TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1931

No. 349

OLD COLONY RAILROAD COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITION FOR CERTIORARI FILED SEPTEMBER 3, 1931

CERTIORARI GRANTED OCTOBER 26, 1931

(36,163)

( )

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INDEX

	Original	Print
Proceedings in United States circuit court of appeals, first circuit	1	1
Caption (omitted in printing)	1	
Proceedings before U. S. Board of Tax Appeals	1	1
Docket entries	1	1
Petition	4	3
Exhibit A—Notice of deficiency with attached statement	12	11
Exhibit B—Lease	18	16
Answer	25	22
Motion for permission to file amended petition	27	25
Amended petition	28	25
Memorandum re Exhibit "A"	35	31
Exhibit "B"—Notice of deficiency, December 11, 1925	35	31
Memorandum re Exhibit "C"	41	37
Answer to amended petition	42	37
Motion for severance of issues, etc	44	39
Findings of fact and opinion, Trussell, M	45	40
Notice of settlement	68	60
Order of redetermination	69	61
Motion for reconsideration	70	62
Joint motion for rescission of final order	72	64
Stipulation re additional finding of fact	72	64
Order denying motion for reconsideration	74	66
Petition for review and notice of filing	76	67
Præcipes	81	71
Opinion, Lowell, J	85	73
Final decree	87	75
Clerk's certificate (omitted in printing)	88	
Order allowing certiorari		77

[fols. a-1] [Caption omitted]

BEFORE U. S. BOARD OF TAX APPEALS

Docket No. 18813

OLD COLONY RAILROAD COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appearances:

For Petitioner: Jos. D. Brady, Esq., J. S. Y. Ivins, Esq.
For Respondent: A. H. Fast, Esq., A. H. Murray, Esq., Lionel A. Norman, Esq.

DOCKET ENTRIES

1926.

July 23. Petition received and filed.
July 24. Copy of petition served on Solicitor.
July 24. Notification of receipt mailed taxpayer.
Sept. 21. Answer filed by General Counsel.
Sept. 25. Copy of answer served on taxpayer—General Calendar.

[fol. 2]

1928.

Apr. 27. Motion to place on Boston, Mass. Circuit Calendar filed by taxpayer. Granted 4/28/28.
May 31. Hearing date set July 31, 1928—Boston, Mass.
June 18. Notice of appearance of Jos. D. Brady as counsel for taxpayer filed. See 16815.
July 6. Hearing date set 8/3/28—Boston, Mass.
Aug. 3. Hearing had before Mr. Trussell on merits. Taken under submission upon filing of a stipulation on 9/6/28. Stipulation of some facts filed. Briefs due Oct. 15, 1928.
July 25. Answer to amended petition filed by General Counsel in field. Copy served 9/13/28.
July 25. Motion for permission to file amended petition filed by taxpayer. Granted. Amended petition filed with motion.

1928.

Aug. 3. Motion for severance of issues and limitation of hearing to certain issues filed by taxpayer—granted.

Aug. 15. Copy of motion and amended petition served on General Counsel.

Aug. 23. Motion for an extension to Sept. 15, 1928 to file stipulation, filed by taxpayer.

Aug. 24. Granted. Both sides notified.

Aug. 30. Transcript of hearing of Aug. 3, 1928 filed.

Sept. 15. Motion for extension to Nov. 1, 1928 to file stipulation or present motion for the taking of testimony, filed by General Counsel. Granted 9/18/28.

Oct. 13. Motion for extension to Dec. 1, 1928 to file brief filed by General Counsel.

Oct. 16. Motion granted to both parties.

Oct. 27. Supplemental stipulation of facts filed.

Nov. 30. Motion for extension to Jan. 10, 1929 for filing briefs filed by General Counsel. Granted both parties 12/3/28.

[fol. 3]

1929.

Jan. 7. Motion for extension to Jan. 31, 1929 for filing briefs filed by General Counsel. Granted 1/8/29.

Jan. 31. Request for findings and brief filed by taxpayer.

Jan. 31. Brief filed by General Counsel.

Nov. 19. Findings of fact and opinion rendered, Sumner L. Trussell, Division 6.

Judgment will be rendered pursuant to Rule 50.

Nov. 22. Notice of settlement filed by taxpayer. 11/25/29 copy served on General Counsel.

Nov. 23. Hearing set Dec. 11, 1929 on settlement.

Dec. 11. Hearing had before Mr. Arundel on settlement under Rule 50.

Assigned to Mr. Trussell for order.

Dec. 16. Order of redetermination entered—Sumner L. Trussell, Division 6.

1930.

Jan. 28. Motion to reopen case filed by General Counsel.

Jan. 30. Hearing set Feb. 19, 1930 on motion.

1930.

Feb. 6. Order that hearing on motion be had Feb. 11, 1930 entered.
Feb. 11. Hearing had before Mr. Trussell on motion for reconsideration and amendment of findings of fact. C. A. V.
Mar. 8. Transcript of hearing of Feb. 11, 1930 filed.
May 24. Joint motion for recission of final order filed. 5/24/30 granted.
June 11. Stipulation for additional finding of fact filed.
June 19. Order denying motion for reconsideration and reinstating final determination entered.
Sept. 29. Petition for review by U. S. Circuit Court of Appeals (1) with assignments of error filed by General Counsel.
Oct. 1. Proof of service filed.
Oct. 9. Proof of service filed (taxpayer).
Oct. 9. Præcipe filed by General Counsel.
Oct. 16. Proof of service filed.

[fol. 4]

Oct. 16. Præcipe filed by taxpayer.
Oct. 20. Proof of service filed.

Now, November 18, 1930, the foregoing Docket Entries certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

PETITION—Filed July 23, 1926

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:CR:RR-60D-RWH) dated May 29, 1926, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized and existing under the laws of the Commonwealth of Massachusetts, and its principal office is at South Station, Boston, Mass.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to the petitioner on May 29, 1926.

3. The taxes in controversy are income taxes for the calendar year 1921 in the amount of one hundred and seventy-three thousand two hundred ninety-seven and seventeen one-hundredths dollars ($173,297.17). The Commissioner asserts a deficiency of seventeen thousand one hundred seventy-two and seventy-five one-hundredths dollars ($17,172.75), while the petitioner asserts that it or its lessee, The New York, New Haven and Hartford Railroad Company (hereinafter called the New Haven), is entitled to a refund of the entire amount of income taxes which have heretofore been paid with respect to the petitioner's net income for the year 1921, the petitioner and the New Haven having been affiliated during said year and the said New Haven having had a deficit in net income large enough completely to absorb the net income of the petitioner, [fol. 5] computed as for a non-affiliated company, and all other companies properly includible in the consolidated return of said New Haven.

The petitioner further asserts that even if it were not affiliated with the New Haven during 1921, it nevertheless would be and is entitled to a refund for said year in the sum of $68,763.62.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

a. The Commissioner erroneously ruled that the petitioner was not affiliated during the calendar year 1921 with the said New Haven, and erroneously computed the petitioner's tax as a separate, individual and non-affiliated company.

b. The Commissioner erred in ruling that the total or gross rental received by the petitioner in 1921 was two million, one hundred nine thousand, two hundred fifty-seven and thirty-one one-hundredths dollars ($2,109,257.31), consisting, as alleged by the Commissioner, of dividends on petitioner's stock of $1,560,580, interest on funded debt $538,920, compensation of officers $3,900, and ordinary and necessary expenses of $5,857.31. The Commissioner further erred in ruling that the petitioner's net income from rent

of road was $1,560,580. The petitioner asserts that the gross rental received from the New Haven or otherwise was $1,422,333.31, made up of $875,656, dividends on petitioner's stock and the other three items as asserted by the Commissioner; and the petitioner further asserts that its net income from rent of road was $873,608, and not $1,560,580 as asserted by the Commissioner. The petitioner further asserts that its gross income from all sources in 1921 was $1,422,381.31, consisting of the aforesaid gross income from rent of road and the sum of $48, dividends on eight (8) shares of the capital stock of the Providence, Warren and Bristol Railroad Company (hereinafter called the Bristol), owned by the petitioner in 1921. The petitioner further asserts that its net income for 1921 was $873,656, and its taxable net income was the said sum of $873,656 minus the said dividends of $48.

[fol. 6] c. The Commissioner erred in adding to the taxable income for 1921 an amount of $6,960.64, representing an apportionment of premiums on bonds between 1895 and 1904.

d. The Commissioner erred in adding to the taxable income for 1921 an amount of $7,223.93, representing an alleged gain on the sale of certain parcels of real estate over and above the gain of $644.20 erroneously reported by the petitioner on its original return.

e. The Commissioner erred in adding to the taxable income for 1921 an amount of $157,542.88, said sum being equivalent to the federal income taxes accrued against the petitioner for said year and paid and/or alleged to be payable by the petitioner's lessee.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

a. (1) That the Old Colony Railroad Company is a corporation existing under and by virtue of the laws of Massachusetts, having been incorporated March 27, 1872, by chapter 143 of the Massachusetts Acts and Resolves of that year. By said act the Old Colony and Newport Railway Company and the Cape Cod Railroad Company were authorized to unite and form one corporation. The act further authorized the Old Colony and Newport Railway Com-

pany, after the union, to change its name to Old Colony Railroad Company. Said act was accepted by the stockholders of each company on April 12, 1872. By said act of 1872 and the several acts supplementary thereto and amendatory thereof, the Old Colony Railroad Company was authorized to acquire, construct and operate a railroad.

(2) That in pursuance of the authority granted to it by said acts, the Old Colony Railroad Company acquired, constructed and operated various railroad lines and properties and was in possession of and operated the same on February 28, 1893.

(3) That on and prior to February 15, 1893, The New York, New Haven and Hartford Railroad Company was a railroad corporation, organized and existing under the laws [fol. 7] of Connecticut and Massachusetts, and operated a railroad in the States of Connecticut and Massachusetts.

(4) That on or about February 15, 1893, the Old Colony Railroad Company and The New York, New Haven and Hartford Railroad Company, deeming it to their mutual interest that their respective lines be merged into and operated as a single railroad system or unit, the Old Colony Railroad Company leased its lines and property to The New York, New Haven and Hartford Railroad Company by a lease dated February 15, 1893, copy of which lease is attached hereto and made a part hereof as "Exhibit B".

(5) That the said lease was executed in pursuance of the authorization of the stockholders of the said Old Colony Railroad Company granted February 28, 1893, and of the authorization of the stockholders of The New York, New Haven and Hartford Railroad Company, granted April 4, 1893.

(6) That said lease was approved and confirmed by an act of the Rhode Island Legislature, passed April 25, 1893, January Session, 1893 Laws, page 380, and by the Legislature of the State of Connecticut by an act of June 14, 1889, Special Laws, Volume 10, page 1298, as amended by an act of March 2, 1893, Special Laws, Volume 11, page 32, which amended the charter of The New York, New Haven and Hartford Railroad Company so that it could exchange its stock for stock of any company wholly or partly in an

adjoining state whose property it might hold by lease. This lease was also made under the General Railroad Law of Massachusetts, Public Statutes, Chapter 112, Sections 220 and 221, and in an opinion of H. M. Knowlton, Attorney General, given March 16, 1894, was declared legal under that statute.

(7) That subsequent to March 1, 1893, and during the year 1921, by virtue of the aforementioned lease, the Old Colony Railroad Company was operated as an integral part of The New York, New Haven and Hartford Railroad Company's railroad system.

(8) That during the year 1921 The New York, New [fol. 8] Haven and Hartford Railroad owned 98,132 shares of the outstanding 222,940 shares of common stock of the Old Colony Railroad Company, being 44 percent of said outstanding common stock of the Old Colony Railroad Company, that each share of said common stock was entitled to one vote, and that there was no other class of stock outstanding.

b. (1) The aforesaid lease of February 15, 1893 (Exhibit B), provided, in part, that the lessee would "pay as rent hereunder * * * sums equal to dividends at the rate of seven percent per annum, payable quarterly, upon said capital stock outstanding".

(2) Said lease also provided, "Nothing herein contained shall prevent the lessor and lessee from modifying, changing, amending, annulling or cancelling this lease by mutual agreement."

(3) During the year 1921 the petitioner had outstanding 222,940 shares of capital stock of which the New Haven owned 98,132 shares. The actual sum received by the petitioner from the New Haven as rent in 1921 was $873,656, it being previously understood and agreed by and between the petitioner and the New Haven that, in accordance with the lease, the provisions thereof as originally made were modified so as to relieve the New Haven of obligation to pay as rent any sum whatever with reference to the share of the petitioner's capital stock owned by the New Haven.

(4) By virtue of the first paragraph of said lease of February 15, 1893, the petitioner demised and let for said term

"all and singular its railroads and property of every description * * * together with the right to demand and receive for the lessee's own use all tolls, rents, income and profits of the demised premises, including also therein all the right, title and interest of the lessor in and to any stock and securities of other corporations owned by it, or held by or for it, all dividends thereon, and the right of voting on the same. * * *" The said lease also provided that "the lessee covenants that it * * * will also return or deliver, [fol. 9] in lieu of the personal property set out in the inventory hereinafter provided to be made, the same or other personal property of similar character, value and uses, and appropriate for the operation of the lessor's railroads", and further provided, "and the parties hereto mutually agree that an inventory and appraisal of all the personal property, including stocks and securities held by the lessor, shall be made as of the first day of March, 1893. * * *"

(5) On the first day of March, 1893, the petitioner was the owner of eight (8) shares of the capital stock of the Bristol, and the certificate therefor was duly delivered by the petitioner to the New Haven.

(6) During the year 1921 the said certificate was still held by the New Haven as lessee, and a dividend of $6 per share was declared and paid thereon in said year.

(7) The sum of $48 was paid to and received by the New Haven.

c. (1) The petitioner, since its lease to the New Haven in 1893 through and including the year 1921, was an inactive and non-operating company.

(2) Bonds were issued by the petitioner between the years 1895 and 1904, the petitioner receiving therewith premiums on bonds during said period amounting to $199,528.08.

(3) The premiums so received have been considered by both the petitioner and the New Haven as part of the surplus of the petitioner and as a closed transaction.

(4) The taxpayer at the direction of the Interstate Commerce Commission in 1914 transferred from the "Premium on Bonds Account" (into which the premium had been

placed when the bonds were sold) into "Capital Profit and Loss Account" the amount of $113,274.36, representing the amount of premiums amortized up to June, 1914, as determined by the said Commission.

(5) Since June, 1914, there has been transferred from the "Premium on Bonds Account" to "Profit and Loss Account" (surplus) on the taxpayer's books, but to income [fol. 10] for federal tax purposes, as prescribed by the Bureau of Internal Revenue, an amount of $3,960.64, representing the yearly apportionment of premiums on bonds as determined by the Commissioner.

(6) The aforesaid treatment of the premiums on bonds received by the taxpayer prior to 1909 has been solely according to the instructions of the Interstate Commerce Commission and the Commissioner of Internal Revenue and not according to the petitioner's interpretation of what the premiums on bonds so acquired represented, namely, a part of its surplus and a closed transaction prior to the year 1909.

d. (1) The aforesaid lease of February 15, 1893, provides, in part, as follows:

"And the lessor hereby makes, constitutes and appoints the lessee its true and sufficient and lawful attorney from time to time, to bargain and sell, with the assent of the directors of the lessor, lands and structures of the lessor on such terms as to the lessee shall seem meet, and hereby authorizes the lessee in the name of the lessor to make, execute, acknowledge and deliver good and sufficient deeds and conveyances of all the right, title and interest of the lessor so bargained and sold in and to the same; the lessor agreeing, whenever thereto requested by the lessee, and upon reasonable notice, to affix its corporate seal to such deeds and conveyances; and the lessee covenants and agrees that other lands and structures of equal value shall be conveyed to the lessor in lieu of any lands or structures so sold and conveyed, * * *"

(2) Several parcels of real estate of the petitioner were sold during the year 1921 and the petitioner on its original return showed a profit thereon of $664.20, which profit the Commissioner has increased to the sum of $7,888.13.

(3) The proceeds of said sales, viz, $63,982.45, were retained by the New Haven in accordance with the terms of the aforesaid lease, the said New Haven being obligated to [fol. 11] convey to the petitioner "other lands and structures of equal value * * * in lieu of (the) lands or structures so sold or conveyed".

6. The petitioner prays for relief from the deficiency asserted by the respondent on the following and each of the following particulars:

a. That the Board find that the petitioner was affiliated with the New Haven during the calendar year 1921, and entitled to a refund of all taxes for said year heretofore paid.

b. That the Board find that the taxpayer did not realize any taxable income in 1921 by reason of the payment in 1922 of the petitioner's federal income taxes by the New Haven.

c. That the Board find that the petitioner did not realize any taxable income in 1921 by reason of the apportionment of premium on bonds sold between the years 1895 and 1904.

d. That the Board find that the petitioner did not realize any taxable income in 1921 by reason of the sale by the New Haven of land or structures of the petitioner.

e. That the Board find that the gross income of the taxpayer was as follows:

(1) Rent	$873,656.00
(2) Interest	538,920.00
(3) Salaries of officers, etc.	9,757.31
(4) Dividends on Bristol stock	48.00
Total gross income	$1,422,381.31

f. That the Board find the petitioner was entitled to the following deductions:

(1) Interest on indebtedness	$538,920.00
(2) Salaries of officers, etc.	9,757.31
(3) Payment to lessee in diminution of net rental for road	48.00
Total deductions	$548,725.31

[fol. 12] g. That the Board find that the petitioner's net income was $873,656 and that its taxable net income was $873,608.

h. That the Board grant such further and other relief as to it may appear just and equitable.

Wherefore, petitioner prays that this Board may hear and redetermine the deficiency herein alleged.

Joseph D. Brady, Counsel for Petitioner, 229 Railroad Office Building, New Haven, Connecticut.

Duly sworn to by Fayette S. Curtis. Jurat omitted in printing.

EXHIBIT A TO PETITION

Treasury Department, Washington

Office of Commissioner of Internal Revenue

IT:CR:RR-60D RWH

May 29, 1926.

Old Colony Railroad Company, South Station, Boston, Massachusetts.

SIRS: A reexamination of your income tax return for the year 1921 together with the information heretofore submitted discloses a tax deficiency of $17,172.75 for the year [fol. 13] in question as shown in the attached statement and accompanying schedules.

In accordance with the provisions of Section 274 of the Revenue Act of 1926, you are allowed 60 days from the date of mailing of this letter within which to file a petition for the redetermination of this deficiency. Any such petition must be addressed to the United States Board of Tax Appeals, Earle Building, Washington, D. C., and must be mailed in time to reach the Board within the 60-day period, not counting Sunday as the sixtieth day.

Where a taxpayer has been given an opportunity to file a petition with the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has filed a

petition and an assessment in accordance with the final decision on such petition has been made, the unpaid amount of the assessment must be paid upon notice and demand from the Collector of Internal Revenue. No claim for abatement can be entertained.

If you acquiesce in this determination and do not desire to file a petition with the United States Board of Tax Appeals, you are requested to execute a waiver of your right to file a petition with the United States Board of Tax Appeals on the enclosed Form A, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CR:RR-60D-RWH. In the event that you acquiesce in a part of the determination, the waiver should be executed with respect to the items to which you agree.

Respectfully, D. H. Blair, Commissioner, by C. R. Nash, Assistant to the Commissioner.

Enclosures: Statement. Form 882. Waiver—Form A. Schedules 1 and 2.

[fol. 14] Statement of Returns Examined and Resulting Tax Liability

IT:CR:RR-60D RWH

Company	Year	Form
Old Colony Railroad Company Boston Massachusetts	1921	1120

Tax Liability

Company	Year	Deficiency
Old Colony Railroad Company	1921	$17,172.75

Full details of the adjustments producing the above stated results are contained in the attached schedules 1 and 2.

In the determination of the above-mentioned tax liability due consideration has been given to the statements set forth in your claim for refund of $156,124.42 corporation income tax for the year 1921 and the findings of the Bureau with respect thereto were embodied in office letter dated December 11, 1925.

Careful consideration has been given the facts and data contained in your briefs dated February 5 and March 9, 1926 and a letter dated March 10, 1926.

Dividends on Stock of the Providence, Warren and Bristol Railroad Company.

The information submitted in your letter of March 10, 1926 has been given careful consideration with respect to your contentions anent the dividends on stock of the above-named company; however your contentions are considered untenable for the following reasons:

Under the provisions of your lease with the lessee you have leased all your property of every kind except your corporate seal and books. The lessee is entitled to all income from the leased property whether operating or non-operating revenues. The dividends in question are income to the lessee, just as much as the operating revenues that it receives. The lessor in receiving the dividends is acting only as an agent for the lessee; therefore it is held that the [fol. 15] aforementioned dividends received by the lessor and which belong to the lessee under the terms of the lease do not constitute income taxable or non-taxable to the lessor, and may not be considered as diminishing the rent payable. It is further held that the decisions at the United States Board of Tax Appeals in the matter of the Appeals of Anthony Schneider and Richard M. C. Glenn, Dockets # 4519 and # 4520 respectively are not applicable in the instant case.

A waiver which will expire December 31, 1926 is on file for the year 1921.

A carbon copy of this letter has been mailed to Mr. Elmont B. Hazard, care of Messrs. Holmes and Brewster, 815 Fifteenth Street, N. W. Washington, D. C. Messrs. Holmes, Lynn, Paul and Havens, 15 William Street, New York, N. Y. and Mr. Joseph D. Brady, Assistant Commerce Counsel, The New York, New Haven and Hartford Railroad Company, New Haven, Connecticut, in accordance with specific instructions in power of attorney running to the aforesaid and on file in this office.

Old Colony Railroad Company. Year Ended December 31, 1921

Schedule 1

Net Income

Net income as disclosed by Bureau Letter dated December 11, 1925		$1,812,143.22
As corrected		1,732,971.65
Deductions		$79,171.57
Deductions:		
(a) Income from lease of road	$5,000.00	
(b) Donations	33,142.83	
(c) Profit on sale of lands	33,831.33	
(d) Federal income tax payable by the lessee	7,197.41	
Total deductions		$79,171.57

[fol. 16] Schedule 1-a

Reasons for Changes

(a) The amount of $5,000.00 purporting to be income from lease of road, which was added to your taxable income in Bureau letter dated December 11, 1925, is hereby reversed, for the reason that it was shown in conference held March 3, 1926, that this amount represented payments made into a sinking fund, which has been held to be the property of the lessee of your railroad and is not income to you.

(b) It is held that the amount of $33,142.83, representing cost of various sidetracks in your gross income in Bureau letter of December 11, 1925 as "Donations" (constructed and paid for by others) do not come into your possession until the expiration of your lease with the New York, New Haven and Hartford Railroad Company, seventy-one years hence: therefore the only profit that would be realized by you as lessor would be the present worth of $33,142.83, discounted at six per cent for seventy-one years which amount is negligible and the adjustment made in the aforemen-

tioned letter in schedule 1, Item (c), is reversed. Reference: Mim 2714 (4 C. B. 90).

(c) The taxable profit on sale of lands is recomputed in accordance with Article 1562 of Regulations 62 and facts and data submitted in conference held on March 3, 1926 and in briefs dated February 5 and 9, 1926, as follows:

[fol. 17] Old Colony Railroad Company. Year Ended December 31, 1921

Kind of property	Date acquired	Cost	March 1, 1913, value	Proceeds	Net profit
Land, Walpole, Mass..	1891	$34.98	$29.30	$50.00	$15.02
Land, Kingston, Mass.	1879	364.14	220.00	300.00	.....
Land, Mansfield, Mass.	1889	2,416.44	4,950.00	3,200.00	.....
Land, Wrentham, Mass.	1889	258.00	3,190.00	4,000.00	810.00
Land, Quincy, Mass..	1911	15.84	26.40	50.00	23.60
Land, Wareham, Mass.	1890	52.18	240.00	260.00	20.00
Land, Boston, Mass...	1845	5,039.40	7,815.00	10,000.00	2,185.00
Land, Boston, Mass...	1874	3,219.00	3,390.00	5,085.30	1,695.30
Land, Boston, Mass...	1845	8,990.00	36,735.79	40,000.00	3,264.21
House, Wareham, Mass.	1877	2,000.00	300.00	175.00	125.00 D
Land, Roxbury, Mass..	1895	922.08	707.25	862.15	.....
		$24,212.06	$57,603.74	$63,982.45	$7,885.13
Amount included in gross income in Bureau letter dated December 11, 1925					41,719.46
Net decrease as above					$33,831.33

D—Denotes loss.

(d) Federal income and profits taxes assumed by the lessee for the lessor is held to be taxable income from rental to the lessor in accordance with article 547 of Regulations 62 and until the Commissioner of Internal Revenue is convinced through the judicial expressions of the courts or otherwise, that this decision is erroneous the Unit will require the inclusion of such items in the taxable income of lessor companies; furthermore, this item is not a deductible expense within the meaning of Article 131 of Regulations 62; therefore, the adjustment shown below is made with respect to corporation income and profits taxes payable by the lessee of your road:

Federal income taxes adjusted in Bureau letter dated December 11, 1925	$164,740.29
Accrued Federal income taxes	157,542.88
Net decrease as above	$7,197.41

[fol. 18] Old Colony Railroad Company. Year ended December 31, 1921

Schedule 2

Computation of Tax, 1921 Rates

Income Tax

Net income taxable year taxable at 10%	$1,732,971.65	$173,297.17
Previously assessed		156,124.42
		$17,172.75

Since the excess profits credit is in excess of the taxable income there is no excess profits tax liability.

Exhibit B to Petition

The Old Colony Railroad Company (hereinafter called the lessor), hereby demises and lets, for the term of ninety-nine years beginning the first day of March, 1893, unto The New York, New Haven and Hartford Railroad Company (hereinafter called the lessee), and to its successors and assigns, both the lessor and lessee being corporations existing under the laws of the Commonwealth of Massachusetts and whose roads connect with each other, all and singular its railroads and property of every description, whether within its location or not, including all rights, franchises, easements, privileges and appurtenances thereunto belonging, together with the right to demand and receive for the lessee's own use all tolls, rents, revenues, income and profits of the demised premises, including also therein all the right, title and interest of the lessor in and to any and all railroads operated by it, under lease or otherwise, and in or to any stock and securities of other corporations owned by it, or held by, or for it, all dividends thereon, and the right of voting on the same, and in and to all contracts and obligations of or with other railroads, corporations or individuals, and all income advantages and benefits to be [fol. 19] derived therefrom, hereby assigning and transferring unto the lessee, under the terms and provisions of this

lease, and for the purposes thereof, and subject to all obligations and incumbrances thereon, all its railroad, property, franchises and assets of every description, however described and wherever situated, except the corporate seal, the stockholders' and directors' record books, and the transfer and stock books, to which the lessee may have access at reasonable times.

And the lessor covenants with the lessee that it will suffer and permit the lessee, it keeping all the covenants on its part as herein contained, to occupy, possess and enjoy said premises, property, rights, franchises and privileges during the term aforesaid without hindrance or molestation.

And the lessor hereby makes, constitutes and appoints the lessee its agent during the term of this lease to operate all its leased railroads and property, the lessee herein to do and perform as such agent all acts with reference thereto incumbent by law or by contract upon the lessor herein and in consideration thereof to receive the income and profit arising from such operations; and the lessor hereby agrees, as soon as it legally may, to make from time to time proper and complete assignments to the lessee of all leasehold rights of the lessor.

And the lessor covenants that during the continuance of this lease it will maintain its corporate organization, the lessee paying all reasonable and proper expenses thereof, and, for that purpose will hold all necessary meetings, elect all necessary officers and make all necessary records, reports, reissues of stock certificates, and transfers and registrations of bonds; and that it will, from time to time, whenever requested by the lessee, take real estate for the convenient operation of said railroads, the lessee, however, advancing therefor all damages and expenses; and that the lessee may use the lessor's name in bringing or defending any suits or proceedings so far as it is or may be necessary for the protection or enjoyment of said demised [fol. 20] premises, property, rights, franchises and privileges, or for the acquisition of additional real estate, but at the sole expense of the lessee, saving the lessor harmless from all loss, costs or damagse thereby accruing.

And the lessor covenants that, for the purpose of making permanent improvements upon the property hereby demised and for the purpose of discharging its indebtedness, it will at the request of the lessee make such lawful issue, and reissue in renewal, of bonds or of stock, or both, as shall from time to time be necessary and proper to be issued; and that at the request of the lessee it will execute mortgages of said demised premises or any part thereof to secure the payment of the principal and interest of such bonds; and that it will not issue any stock or bonds, or create any indebtedness or lien upon said demised premises, or property, except under and in accordance with the directions, or by the previous written consent, of the lessee.

And the lessor hereby makes, constitutes and appoints the lessee its true and sufficient and lawful attorney from time to time, to bargain and sell, with the assent of the directors of the lessor, lands and structures of the lessor on such terms as to the lessee shall seem meet, and hereby authorizes the lessee in the name of the lessor to make, execute, acknowledge and deliver good and sufficient deeds and conveyances of all the right, title and interest of the lessor so bargained and sold in and to the same; the lessor agreeing, whenever thereto requested by the lessee, and upon reasonable notice, to affix its corporate seal to such deeds and conveyances; and the lessee covenants and agrees that other lands and structures of equal value shall be conveyed to the lessor in lieu of any lands or structures so sold and conveyed, and that if the lessee shall under any power herein conferred sell or abandon the lands and structures now constituting the terminals leased to the lessor in the city of Providence, the lessee shall acquire, construct and convey to the lessor of the lessor herein new terminals of equal value and sufficient for its business, and [fol. 21] to be such as will conform to the agreements of the lease of the Boston and Providence Railroad Corporation to the lessor: all property so acquired to become a part of the demised premises.

And the lessor covenants that it will at any time or times hereafter upon the reasonable request of the lessee, make, do, and execute, or cause, or procure to be made, done and executed all and every such further and other lawful and reasonable acts, conveyances, transfers, assignments and assurances in the law, for the better and more effec-

tually vesting and confirming the premises and property hereby leased, or intended so to be, in and to the lessee, as by the lessee shall be reasonably devised, advised or required.

And the lessee covenants to pay as rent hereunder on the 30th day of June, 1893, a sum equal to a dividend of two dollars and thirty-three and one-third cents upon each share of the capital stock of the lessor then outstanding; and thereafter, except as hereinafter provided, sums equal to dividends at the rate of seven per cent per annum, payable quarterly, upon said capital stock then from time to time outstanding.

And the lessee further covenants that as soon as it lawfully may, it will prior to January first, 1900, issue in the proportion of nine shares of its capital stock in exchange for ten shares of the capital stock of the lessor, then outstanding, and will give notice thereof by mail to each stockholder of the lessor and thereafter, and until six months after said exchange shall be offered to the stockholders of the lessor, upon the assignment to the lessee of ten shares of the capital stock of the lessor or any multiple thereof, and the surrender of the certificate or certificates therefor, the lessee will, whenever its stock transfer books are open, issue to the owner of said shares in exchange therefor, a certificate for the proportionate number as above provided, of shares of the capital stock of the lessee.

And the lessee covenants that in case it shall be unable to perform the covenants contained in the preceding para- [fol. 22] graph prior to the first day of July, 1893, it will thereafter, and between said first day of July, and six months after the date when it shall be able to perform said covenants, pay (in lieu of said sums equal to dividends at the rate of seven per cent per annum) a sum on each share of the outstanding capital stock from time to time of the lessor equal to nine tenths of such dividends as the lessee shall pay upon each share of its own capital stock and will secure to the stockholders of the lessor the same proportion of such pecuniary privileges as the lessee shall give upon each share of its own capital stock.

And the lessee further covenants to provide for the payment in the manner hereinbefore mentioned, of the principal of all funded indebtedness for the payment of which

the lessor may be legally holden as the same shall from time to time mature, and to assume and pay all the other obligations of the lessor of every name and nature as the same shall from time to time fall due, and to keep and perform all and singular the contracts relating to said demised premises and property now in force and binding on the lessor, whether arising under leases or otherwise, and as to property leased to the lessor, the lessee shall be subject to the leases under which such property is held.

And the lessee further covenants to pay, during each year of said terms, all taxes, rates, charges and assessments, ordinary and extraordinary, which may be lawfully imposed or assessed in any way upon the lessor or lessee with reference to the premises and property hereby demised, the capital stock of the lessor, its indebtedness, franchises and revenues or said rental; said payments to be made to the authority or treasurer entitled by law to receive the same, whether Federal, State or municipal, so that said lessor shall be saved harmless, during the continuance of this lease from any tax, assessment or charge under laws or proceedings made or authorized by the United States or any State or municipality.

Provided, that (1) if the lessee shall at any time fail to pay the interest on the lessor's bonded indebtedness when [fol. 23] the same falls due, or (2) if the lessee shall fail for thirty days to make any quarterly payment of rent as above stipulated, or (3) if the lessee shall fail to keep or perform any other of its covenants or agreements in this lease contained, and such default shall continue for six months after written notice thereof shall have been given by the lessor to the lessee; then, and in either of said events, this lease shall expire and terminate, at the option of the lessor, and the lessor may thereupon re-enter upon the demised premises, and the same have and possess as of its former estate without prejudice to its right of action for arrears of rent or breach of covenant.

And the lessee covenants that it will at its own cost and expense during the continuance of this lease, furnish and provide all such books, forms and papers, and do and perform all such acts and things as may be required for the proper distribution of dividends, payment of interest and for the issue, record and transfer of the stock of the lessor,

and for the issue, registration and transfer of any bonds herein referred to, as a part of the expenses of organization.

And the lessee covenants that it will operate the lessor's said railroads and the leased railroads of the lessor as required by all legal enactments from time to time in force, and furnish all equipment, in addition to that hereby demised, which may be necessary for such operation, and maintain said demised premises and property during said term in good condition and up to its present standard as a railroad; and that it will make all additions, alterations, improvements and betterments which may be necessary or proper with reference to the premises and property hereby leased; and that all lands, structures, improvements, betterments and renewals so added to or made upon the real estate hereby demised shall become the property of the lessor, and a part of the demised premises; and that at the expiration of this lease, whether by lapse of time or otherwise, it will deliver to the lessor possession of said demised [fol. 24] premises, and leased properties, rights, franchises and privileges, together with any and all additions and substitutions which may have been made thereto as aforesaid, and will also return or deliver, in lieu of the personal property set out in the inventory hereinafter provided to be made, the same or other personal property of similar character, value and uses, and appropriate for the operation of the lessor's railroads.

And the lessee covenants that it will save the lessor harmless from all suits, costs, damages and expenses by reason of any act or omission of the lessee in the use of said demised premises, under this lease; and will, at its own expense, defend all suits pending or brought against the lessor and pay the judgments therein when demanded on final process; and that it will during said term make all returns required by any laws of the State, or of the United States, in relation to the property hereby leased, to any public officer, or other legal authority; and that, should any returns be required by law of the lessor the lessee will furnish, on demand, so far as it has the means, all information necessary therefor.

And the parties hereto mutually agree that an inventory and appraisal of all the personal property hereby demised,

including stocks and securities held by the lessor, shall be made as of the first day of March, 1893, by representatives of the lessor and lessee, or in case of disagreement as to any item or items by a third person to be agreed upon by the lessor and lessee.

Nothing herein contained shall prevent the lessor and lessee from modifying, changing, amending, annulling or cancelling this lease by mutual agreement.

It is understood that this lease is made subject to approval by the stockholders of said parties respectively as required by law.

In Witness Whereof, the parties hereto, under the authority and direction of their respective Boards of Directors have caused this instrument to be signed by their respective [fol. 25] Presidents and their corporate seals to be hereto affixed, this fifteenth day of February, A. D. 1893.

Old Colony Railroad Company, by Charles F. Choate, President. (Seal.) The New York, New Haven and Hartford Railroad Company, by Charles P. Clark, President. (Seal.)

Witness-: E. G. Parker, J. G. Parker.

(Acknowledgment)

Now, November 18, 1930, the foregoing Petition certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals. (Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

ANSWER—Filed September 21, 1926

The Commissioner of Internal Revenue, by his attorney, A. W. Gregg, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

(1) Admits the allegations contained in paragraph 1 of the petition.

(2) Admits the allegations contained in paragraph 2 of the petition.

(3) Admits that the Commissioner asserted a deficiency of $17,172.75 and admits that more than that amount is now in controversy; but denies that the sum of $173,297.17 represents the taxes in controversy. Denies the remaining allegations contained in paragraph 3 of the petition.

(4) Denies that he committed any of the errors alleged in paragraph 4 of the petition.

(5) a. (1) Admits the allegations contained in sub-paragraph a (1) of paragraph 5.

[fol. 26] (2) Admits the allegations contained in sub-paragraph a (2) of paragraph 5.

(3) Admits the allegations contained in sub-paragraph a (3) of paragraph 5.

(4) Admits that the Old Colony Railroad Company leased its lines and property to the New York, New Haven and Hartford Railroad Company, but for want of information denies that the copy attached to the petition as "Exhibit B" is a true copy of such lease and denies the remaining allegations contained in subparagraph a (4) of paragraph 5.

(5) Admit the allegations contained in subparagraph a (5) of paragraph 5.

(6) Admits the allegations contained in subparagraph a (6) of paragraph 5.

(7) Denies the allegations contained in subparagraph a (7) of paragraph 5.

(8) Denies the allegations contained in subparagraph a (8) of paragraph 5.

(b) For want of knowledge of the terms of the lease referred to in subparagraph b (1) to b (4), inclusive, neither admits nor denies the allegations contained in the said subparagraphs and calls for proof of the same. Denies the remaining allegations contained in subparagraph b.

(c) (1) Admits the allegations contained in subparagraph c (1) of paragraph 5.

(2) Admits the allegations contained in subparagraph c (2) of paragraph 5.

(3) Denies the allegations contained in subparagraph c (3) of paragraph 5.

(4) Admits that under the rules of the Interstate Commerce Commission premiums on bonds should be amortised over the period of the life of the bonds, but for want of information denies that it was necessary for the taxpayer to make the changes alleged in subparagraph c (4) of paragraph 5 in order to comply with the aforesaid rule of the Interstate Commerce Commission.

[fol. 27] c (5) Admits that an amount of $6,960.64 is the yearly apportionment of premiums on bonds as determined by the Commissioner, who treated the same as income for Federal tax purposes, but denies the remaining allegations contained in subparagraph c (5).

c (6) Denies the allegations contained in subparagraph c (6) of paragraph 5.

d (1) For want of information, neither affirms than denies the allegations contained in paragraph d (1) of paragraph 5 and calls for proof of the same.

(2) Admits the allegations contained in subparagraph d (2) of paragraph 5.

(3) Denies the allegations contained in subparagraph d (3) of paragraph 5.

(6) Denies, generally and specifically, each and every allegation in the taxpayer's petition contained not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the taxpayer's appeal be denied.

A. W. Gregg, General Counsel, Bureau of Internal Revenue. Of counsel: M. N. Fisher, Special Attorney, Bureau of Internal Revenue.

Now, November 18, 1930, the foregoing Answer certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

MOTION FOR PERMISSION TO FILE AMENDED PETITION—Filed at hearing and granted July 25, 1928

Comes now the petitioner, by its attorneys, James S. Y. Ivins and Joseph D. Brady, and prays that it be permitted to file an amended petition in the above-entitled case.

In support of its motion, petitioner represents that two [fol. 28] of the issues raised in the original petition are eliminated from the amended petition, and the special attorney, representing the respondent, desires to file an amended answer and has indicated that he has no objection to the filing of an amended petition.

James S. Y. Ivins, Joseph D. Brady, Attorneys for Petitioner,

% Holmes, Brewster & Ivins, 815 Fifteenth Street, N. W., Washington, D. C.

Now, November 18, 1930, the foregoing Motion certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

AMENDED PETITION—Filed at hearing July 25, 1928

The above-named petitioner hereby presents its amended petition (its original petition having been filed July 23, 1926) requesting a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:CR:RR-60D-RWH) dated May 29, 1926, and as the basis of its proceedings alleges as follows:

1. That the petitioner is a Massachusetts corporation, and its principal office is at South Station, Boston, Mass.

2. The notice of deficiency (a copy of which is hereto attached, marked "Exhibit A" and made a part hereof by reference) was mailed to the petitioner on May 29, 1926. Said deficiency notice refers to Bureau 30-day letter to the petitioner, dated December 11, 1925, copy thereof being

attached hereto, marked "Exhibit B" and made a part hereof by reference.

3. The taxes in controversy are income taxes for the calendar year 1921 in the amount of $173,297.17. The Com- [fol. 29] missioner asserts a deficiency of $17,172.75; the petitioner an overpayment of $156,124.42.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in ruling that the petitioner was not affiliated during the calendar year 1921 with The New York, New Haven and Hartford Railroad Company, hereinafter referred to as the New Haven, and erroneously computed the petitioner's tax as a separate, individual and non-affiliated company.

(b) The Commissioner erred in adding to the taxable income for 1921 as reported by the petitioner the amount of $6,960.64, representing an apportionment of premiums on bonds sold between 1894 and 1905.

(c) The Commissioner erred in adding to the taxable income for 1921 as reported by the petitioner the amount of $7,223.93, representing alleged taxable gains or profits arising from the disposition, pursuant to petitioner's lease of certain parcels of real estate or interests therein, over and above the supposed gain or profit of $664.20 erroneously reported by the petitioner.

(d) The Commissioner erred in failing to eliminate from the taxable income for 1921 as reported by the petitioner the amount of $664.20, erroneously supposed by the petitioner to be taxable gain or profit arising from the disposition, pursuant to petitioner's lease, of certain parcels of real estate, or interests therein.

(e) The Commissioner erred in adding to the taxable income for 1921 as reported by the petitioner the amount of $157,542.88, on account of the federal income taxes accrued against the petitioner for said year and paid and/or alleged to be payable by the petitioner's lessee.

(f) The Commissioner erred in failing to find that petitioner had overpaid its income taxes for 1921 in the amount of $156,124.42.

[fol. 30] 5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner is a corporation of the State of Massachusetts, and is the owner of various railroad lines and properties in that State and in the State of Rhode Island.

(b) The New Haven is a corporation of the States of Massachusetts, Rhode Island and Connecticut, and is the owner and lessee of various railroad lines in those states and in the State of New York.

(c) On or about February 15, 1893, petitioner and the New Haven, deeming it to their mutual interest that their respective lines be merged into and operated as a single railroad system or unit, petitioner leased its lines and property to the New Haven by a lease of that date, copy of which is hereto attached, marked "Exhibit C" and made a part hereof by reference.

(d) That said lease was authorized by the stockholders of both companies, and was also made in conformity with the laws of Massachusetts, Rhode Island and Connecticut.

(e) That subsequent to March 1, 1893, and during all the calendar year 1921, the said lease was in full force and effect.

(f) That during all the year 1921, by virtue of said lease, the railroads and property of the petitioner were operated as an integral part of the New Haven's railroad system.

(g) That during all the year 1921, the New Haven owned 98,132 shares of the outstanding 222,940 shares of common stock of the petitioner, being 44 per cent of said outstanding common stock, that each share of said common stock was entitled to one vote, and that there was no other class of stock outstanding.

(h) That there was but one meeting of the stockholders of the petitioner held in 1921. Said meeting was the annual meeting, and was held at Boston on March 29, 1921.

(i) That 98,604 shares, including the 98,132 shares owned by the New Haven, were voted at said meeting by F. S. Curtis.

(j) That 18,118 shares, represented by fifty proxies, were [fol. 31] voted at said meeting by T. W. Hoogs.

(k) That 21,525 shares, represented by eighty-seven proxies, were voted at said meeting by E. M. Glidden.

(l) That a total vote of 138,247 shares was cast at said meeting, and said votes were unanimous.

(m) That F. S. Curtis is a former Vice-President of the New Haven, and in addition to being President of the petitioner, for which he received in 1921 a substantial salary, said Curtis is, and was in 1921, President of the Union Freight Railroad Company, all of whose stock was in 1921 controlled by the New Haven, and Chairman of the Trustees of The Boston Terminal Company, 80 per cent of whose stock was in 1921 owned or controlled by the New Haven. For his services in the two last-mentioned capacities said Curtis received substantial salaries in 1921.

(n) T. W. Hoogs had in 1921 been in the service of the New Haven for upward of forty years and received a substantial salary from the New Haven in that year. He was not employed by petitioner.

(o) E. M. Glidden in 1921 was Treasurer of the petitioner, the Union Freight Railroad Company, and The Boston Terminal Company, and received substantial salaries for his services in those capacities.

(p) The practice with respect to voting the stock of the petitioner in 1921, as outlined above, was similar to that followed for several years before and after said taxable year.

(q) Substantially all of the stock of the petitioner was in fact owned and/or controlled by the New Haven in 1921.

(r) The New Haven in 1921 had a deficit in consolidated net income sufficient completely to absorb the income of the petitioner and that of all other companies affiliated with it in said year.

(s) The facts found by the Board of Tax Appeals with respect to bond premiums for the year 1920, Old Colony Railroad Company v. Commissioner of Internal Revenue, [fol. 32] 6 B. T. A. 1025, are incorporated herein by reference, a like situation having existed in 1921.

(t) In Schedule A-23 of its return for 1921, petitioner reported the disposition during that year of eleven parcels of real estate. It reported taxable gains or profits with respect to seven of said parcels aggregating $2,539.20, deductible losses aggregating $1,875 with respect to two of said parcels, and, on the remaining two, neither taxable profits nor deductible losses. The net gain or profit of $664.20, assumed by the petitioner to have been realized, was carried into the net income of $1,561,244.20 shown on the return.

(u) The proceeds of said transactions were received and retained by petitioner's lessee in accordance with the lease, and were never received by petitioner, the petitioner being entitled only to have the lessee convey to petitioner "other lands and structures of equal value * * * in lieu of any lands or structures so sold or conveyed".

(v) In Schedule 1-a of his 60-day letter (Exhibit A) the Commissioner increased the net taxable profit on the aforementioned eleven parcels to $7,888.13, and added to the net income of petitioner, on account of said items, the sum of $7,223.93.

(w) One of said parcels shown in said Schedule 1-a and designated therein as "Land, Boston, Mass. * * * Net Profit $3,264.21", and hereinafter referred to as "Parcel A", in fact related to an assessment in land, of an area of 14,270 square feet, owned by the petitioner, but leased to the New Haven, in the City of Boston. Said easement was taken in May, 1916, by said city for subway purposes. In March, 1917, the petitioner and the New Haven jointly petitioned the Superior Court for Suffolk County, Massachusetts, for assessment of damages. Said action embraced a claim of the petitioner with respect to the easement taken as well as for consequential damages to adjoining property not taken; also a claim by the New Haven for damages arising out of said taking. Said action was compromised and settled in March, 1921, for the sum of [fol. 33] $40,000. Said sum was received by the New Haven, which as lessee was entitled to the use of the property taken, and was never received by the petitioner.

(x) Another of said parcels shown in said Schedule 1-a and designated therein as "Land, Quincy, Mass. 1911

* * * Net Profit $23.60", and hereinafter referred to as "Parcel B", in fact related to land, of an area of 132 square feet, more or less, owned by petitioner, but leased to the New Haven, in the City of Quincy, taken in September, 1919, by said city for highway purposes under its power of eminent domain. The damages of $50 from said taking were received by the New Haven as in the case of "Parcel A".

(y) Another of said parcels shown in said Schedule 1-a and designated therein as "Land, Wareham, Mass. 1890 * * * Net Profit $20.00", and hereinafter referred to as "Parcel C", in fact related to land, of an area of 39 square rods, owned by the petitioner, but leased to the New Haven, in the City of Wareham. Said land was taken in June, 1920, for highway purposes, by the Cohasset Narrows Bridge Commission under its power of eminent domain. The damages of $260 from said taking were received by the New Haven as in the case of "Parcel A".

(z) The remaining eight parcels shown in said Schedule 1-a and not specifically mentioned above were sold by petitioner's lessee in accordance with the terms of petitioner's lease. The March 1, 1913 value of said parcels was as found by the Commissioner in Schedule 1-a of his deficiency notice.

(aa) That the federal income taxes of petitioner for 1921 have heretofore been paid in the amount of $156,124.42, no part of which has been refunded.

(bb) That petitioner's books of account were, during the taxable year 1921 and also before and after, kept on the accrual basis.

6. The petitioner prays for relief from the deficiency asserted by the respondent on the following and each of the following particulars:

[fol. 34] (a) That the Board find that the petitioner was affiliated with the New Haven during the year 1921, and has overpaid its federal income taxes for said year in the amount of $156,124.42.

(b) That the Board find that the petitioner did not realize any taxable income by reason of the apportionment of premium on bonds sold between 1894 and 1905.

(c) That the Board find that the petitioner derived no taxable gain or profit from the disposition, pursuant to and in accordance with the terms of its lease, of parcels of real estate.

(d) In the event the Board should find that any of said real estate dispositions resulted in taxable profits, that it also find that no taxable profits were derived in 1921 from property, or interests therein, taken under the power of eminent domain, as in the cases of "Parcel A", "Parcel B" and "Parcel C".

(e) That the Board find that petitioner derived no taxable income from the payment of its federal income taxes by its lessee.

(f) That the Board grant such further and other relief as to it may appear just and equitable.

Wherefore, petitioner prays that this Board may hear and redetermine the deficiency herein alleged.

Joseph D. Brady, Counsel for Petitioner.

c/o Holmes, Brewster & Ivins, 815 Fifteenth Street, N. W., Washington, D. C.

Duly sworn to by Arthur W. Johnson. Jurat omitted in printing.

[fol. 35] EXHIBIT A

[MEMORANDUM.—Exhibit A, already printed at page 12, is here omitted. A: I. Charron, Clerk.]

EXHIBIT B TO AMENDED PETITION

Treasury Department

Office of Commissioner of Internal Revenue

Address reply to Commissioner of Internal Revenue and refer to IT:CR:RR RWH.

Washington, Dec. 11, 1925.

Old Colony Railroad Company, Room 225 South Station, Boston, Massachusetts.

SIRS: An examination of your income and profits tax return for the year 1921 discloses a tax deficiency of $25,-

089.90 for that year as shown in the attached statement and accompanying schedules.

You are granted 30 days from the date of this letter within which to present a protest, supported by additional evidence or brief, against this determination of a deficiency. Any additional evidence submitted should be under oath. Upon request submitted within the period mentioned, you will also be granted a hearing in the Bureau with reference to the matter.

A request for a hearing should contain (a) the name and address of the taxpayer; (b) in the case of a corporation, [fol. 36] the name of the State of incorporation; (c) a designation by date and symbol of the notice or notices with respect to which the hearing is desired; (d) a designation of the year or years involved and a statement of the amount of tax in dispute for each year; (e) an itemized schedule of the findings of the Unit to which the taxpayer takes exception; and (f) a summary statement of the grounds upon which the taxpayer relies in connection with each exception.

If, after consideration of any additional evidence submitted and any arguments advanced by you, a deficiency is finally determined by the Bureau to be due from you, you will, in accordance with the provisions of Section 274 of the Revenue Act of 1924, be advised by registered mail of the final determination of the Commissioner as to the amount of the deficiency, and allowed 60 days from the mailing of the letter in which to file an appeal to the United States Board of Tax Appeals in the event you do not acquiesce in such final determination.

If you acquiesce in the determination of a deficiency as disclosed in this letter and the accompanying statements, you are requested to sign the inclosed agreement consenting to the assessment of such deficiency, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CR:RR-RWH. In the event that you acquiesce in a part of the determination, the agreement should be executed with respect to the items agreed to.

Respectfully, C. R. Nash, Assistant to the Commissioner.

Inclosures: Statements. Agreement—Form A. Schedules 1 and 2.

Form 7860, Aug., 1924.

[fol. 37] IT:CR:RR RWH

Statement of Returns Examined and Resulting Tax Liability

Returns Examined

Company	Year	Form
Old Colony Railroad Company, Boston, Massachusetts	1921	1120

Tax Liability

Company	Year	Additional tax
Old Colony Railroad Company	1921	$25,089.90

Full details of the adjustments producing the above-stated results are contained in the attached Schedules 1 to 2, inclusive.

In the determination of the above corrected tax liability due consideration has been given to the statements set forth in your claim for refund of $156,124.42 corporation income tax for the year 1921.

The claim is based upon the following statements:

(a) That you filed a separate Income and Profits Return, Form 1120, for the year 1921, and paid a tax of $156,124.42 thereon, while as a matter of fact and law said company was affiliated with the New York, New Haven and Hartford Railroad Company during the year 1921. Furthermore, that an examination has been made of the 1921 consolidated return of the New York, New Haven and Hartford Railroad Company and affiliated companies, excluding The Old Colony Railroad Company, with the result that a deficit will be shown large enough completely to absorb any addition to income which would result from the inclusion of this company therein.

(b) The original return of this company included in its net income an amount of $48.00 representing dividend income. This item is not subject to the Normal tax and should be eliminated from this company's taxable net income. Said item is identical with an item of like amount

[fol. 38] referred to and allowed in Treasury Department letter of February 4, 1924.

The findings of the Bureau are as follows:

(a) The question of the affiliation of your company with the New York, New Haven and Hartford Railroad Company for the year 1918 has been made the basis of an appeal to the United States Board of Tax Appeals and in Docket No. 1024, Decision No. 408, April 28, 1925 it was held that your company and the New York, New Haven and Hartford Railroad Company were not affiliated; therefore your contention with respect thereto is hereby denied.

(b) An examination of your return for the year 1921, shows that you have included in gross income, on account of income from lease of road, the sum of $2,109,257.31 and since the lease by the Old Colony Railroad Company to the New York, New Haven and Hartford Railroad Company dated February 15, 1893 provides for an annual rental for exactly the amount shown on your return consisting of:

Dividends on Stock	$1,560,580.00
Interest on Funded Debt	538,920.00
Compensation of Officers	3,900.00
Expenses (Ordinary & Necessary)	5,857.31
	$2,109,257.31

Your contention to exclude the aforesaid amount of $48.00 dividend income is also denied.

A carbon copy of this letter has been mailed to Mr. Elmont B. Hazard, care of Messrs. Holmes and Brewster, 815 Fifteenth Street, N. W., Washington, D. C.; Messrs. Holmes, Lynn, Paul and Havens, 15 William Street, New York, N. Y. and Mr. Joseph D. Brady, Yellow Building, New Haven, Connecticut, in accordance with specific instructions in power of attorney running to the aforesaid and on file in this office.

[fol. 39] Old Colony Railroad Company. Year Ended December 31, 1921

Schedule 1

Net Income

Net income as disclosed by return		$1,561,244.20
As corrected		1,812,143.22
Additions		$250,899.02
Additions:		
(a) Income from lease of road	$5,000.00	
(b) Premium on bonds	6,960.64	
(c) Donations	33,142.83	
(d) Profit on sale of lands	41,055.26	
(e) Federal income tax payable by lessee	164,740.29	
Total additions		$250,899.02

Schedule 1-a

Explanation of Items Changed

(a) In accordance with Article 541 of Regulations 62, gross income embraces not only the operating revenues, but also gains, profits, and income from all other sources; therefore, the difference between the amount of $2,109,257.31 reported on your return as "Income from lease of road" and the amount of $2,114,257.31 shown in your annual report to the Interstate Commerce Commission as income from lease of road is included in your gross income.

(b) The amount of $6,960.64, premium on bonds sold prior to 1919 credited to your income account has been included in your gross income in accordance with Article 545 of Regulations 62.

(c) The amount of $33,142.83 representing donations credited to surplus account is added to your gross income for the reason that such payments are made to the carriers as a result of an obligation arising out of a contract be-
[fol. 40] tween the industry and the carrier, in which the carrier agrees to construct the facility and furnish the necessary service to and from the industry, in consideration of such payments by the industry. It is clear from

the above that such payments are not free and voluntary gifts, and that the agreement by the carrier to construct such facilities, and to furnish the necessary service is a valuable consideration sufficient to support the contract (Reference: ARR 3513 CB 11-2 page 83.) Furthermore, it is held in O. D. 1019 CB 5 page 151 and in ARR 1008 CB 1-2 page 120, that similar payments are deductible as a business expense by the industry making such payment.

(d) The difference between the profit on sale of capital assets of $664.20 shown on original return and the book profit of $41,719.46 credited to profit and loss, is added to your gross income for the reason that a mere statement that the March 1, 1913 value was determined by either appraisal or award is not considered sufficient evidence of the March 1, 1913 value to be acceptible by this office within the meaning of Article 1561 of Regulations 62.

(e) The Unit has consistently held that taxes assumed by the lessee for the lessor, under the provisions of a lease, constitute rental income to the lessor, *under the provisions of a lease, constitute rental income to the lessor,* and should be returned as taxable income to the lessor in accordance with Article 547 of Regulations 62, and until the Commissioner of Internal Revenue is convinced through judicial expressions of the courts, or otherwise, that the above-mentioned ruling is erroneous, the Unit will require the inclusion of such items in the taxable income of lessor companies; therefore, the amount of $164,740.29, Federal income taxes for the year 1921 payable by the lessee of your property has been included in your taxable income.

[fol. 41] Old Colony Railroad Company. Year ended December 31, 1921

Schedule 2

Computation of Tax, 1921 Rates

Income Tax

Net income taxable year taxable at 10%	$1,812,143.22
Income Tax	$181,214.32
Previously assessed	156,124.42
Additional to be assessed	$25,089.90

Inasmuch as the profits tax credit is in excess of the net income subject to such tax no profits tax has been developed.

MEMORANDUM RE EXHIBIT C

Lease by the Old Colony Railroad Company of its main lines and branch lines of railroad extending from Boston, Massachusetts, through Massachusetts and Rhode Island, (534.08 miles) to the New York, New Haven and Hartford Railroad Company for term of ninety-nine years from March 1, 1893. Dated February 15, 1893.

[MEMORANDUM.—The rest of Exhibit C is here omitted as it is identical with Exhibit B, printed at pages 18 to 25 inclusive. A. I. Charron, Clerk.]

Now, November 18, 1930, the foregoing Amended Petition certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

[fol. 42] BEFORE U. S. BOARD OF TAX APPEALS

ANSWER TO AMENDED PETITION—Filed at hearing July 25, 1928

Comes now the Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, and, for answer to the amended petition of this taxpayer, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the amended petition.

2. Admits the allegations contained in paragraph 2 of the amended petition.

3. Admits the allegations contained in paragraph 3 of the amended petition.

4. Denies that the Commissioner erred in his determinations as alleged in paragraph 4 of the amended petition.

5 (a) to (g), incl. Admits the material allegations contained in paragraphs 5 (a) to (q), inclusive, of the amended petition.

5 (h) to (q), incl. Denies the material allegations of fact contained in paragraph 5 (h) to (q), inclusive, of the amended petition.

5 (r.) Denies the material allegations of fact contained in paragraph 5 (r) of the amended petition.

5 (t). Admits the material allegations of fact contained in paragraph 5 (t) of the amended petition.

5 (w) to (z), incl. Admits that taxpayer included in its 1921 return certain profits arising from the sale of eleven certain parcels of land sold in that year.

Alleges that taxpayer in its return for 1922 reported a profit of $99,434.39 on the sale of a certain parcel of land referred to and known as the "Squantum" land. This profit was increased by the Commissioner to $335,500.71 in the deficiency letter covering the year 1922. This tract of land was acquired by petitioner in 1895 at a cost of $206,016.29. The said tract was taken over on October 6, 1917 by the United States Government for war purposes. A dis- [fol. 43] pute arose as to the compensation to be paid therefor which resulted in an action being brought in the Court of Claims. That court on May 31, 1921 rendered judgment against the Government and in favor of this petitioner for $575,000. See Old Colony Railroad Company v. United States, 56 Ct. Cls. 326. The Commissioner contends that the profit on this parcel of land should be excluded from 1922 income and included in 1921 income.

5 (aa). Admits the material allegations of fact contained in paragraph 5 (aa) of the amended petition. The Commissioner alleges that petitioner's net income for 1920 (exclusive of any amount paid or accrued as Federal income or profits taxes) was $1,555,394.85 and the Federal income and profits taxes paid in 1921 by the New Haven on taxpayer's net income was at least $155,339.49, no part of which has been refunded. If the Board finds that the 1921 taxes in the amount of $156,124.42 should not be included in taxpayer's 1921 income then the Commissioner alleges in the alternative that petitioner's 1920 taxes paid by the New Haven

Railroad Company in the amount of $155,339.49 should be included in taxpayer's 1921 income.

5 (bb). Admits the material allegations of fact contained in paragraph 5 (bb) of the amended petition.

Denies generally and specifically each and every other allegation of fact contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore it is prayed that the Commissioner's determination be approved and that the petition be dismissed and the appeal denied.

C. M. Charest, General Counsel, Bureau of Internal Revenue. Of Counsel: A. H. Fast, Special Attorney, Bureau of Internal Revenue.

[fol. 44] Now, November 18, 1930, the foregoing Answer to Amended Petition certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals. (Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

MOTION FOR SEVERANCE OF ISSUES AND LIMITATION OF HEARING TO CERTAIN ISSUES—Filed at hearing and granted August 3, 1928

Now comes the petitioner in the above cause, by its attorneys, James S. Y. Ivins and Joseph D. Brady, and respectfully moves the Board to order a severance of the issues in the above cause and to limit the hearing set for August 3, 1928, to the following issues

(a), (b), (c), (d), (e) and (f) of the amended petition, together with the issues raised by respondent in his answer to the amended petition, exclusive of the matter of March 1, 1913, value.

This motion is submitted for the following reasons:

(a) Were it not for the additional issues raised by respondent in his answer to the amended petition, the entire case could be disposed of by the Board after one hearing;

(b) The respondent, however, in his answer to the amended petition contends that the amount of just compensation awarded by the Court of Claims of the United States in 1921 on account of the taking of certain property by the United States in 1917 for war purposes created a taxable gain to petitioner in 1921. The burden is on respondent to show the amount of gain realized by petitioner and, therefore, he must prove March 1, 1913, value. Petitioner contends that no taxable gain was realized in any year and, in the alternative, that the gain, if any, was realized prior to 1921. If the Board and/or the courts on appeal should hold that the transaction was not taxable at all, or, if taxable, was includible in a year other than 1921, there would be no occasion for the taking of testimony as to March 1, 1913, value.

[fol. 45] (c) Adequately to present evidence as to March 1, 1913, value would entail substantial expenses on the part of both the respondent and petitioner, and would take several days of the Board's time.

(d) Counsel for the respondent has indicated that the procedure above suggested meets with his entire approval.

James S. Y. Ivins, Joseph D. Brady, Counsel for Petitioner.

c/o Holmes, Brewster & Irvins, 815 Fifteenth Street, N. W., Washington, D. C.

August 3, 1928.

Now, November 18, 1930, the foregoing Motion certified from the record as a true copy.

B. D. Gamble, Clerk, U. S. Board of Tax Appeals. (Seal.)

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 18813

OLD COLONY RAILROAD CO., Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Findings of Fact and Opinion—Promulgated November 19, 1929

Income. Leased Property. Taxes Paid by Lessee.—The amount of petitioner's Federal income and profits taxes for

1920, due and payable in 1921 and paid for its account in that year by the lessee of all of its property and business as one of the considerations for the use of the property, Held, to be income to petitioner for 1921. Providence & Worcester Railroad Co., 5 B. T. A. 1186.

Id. Bond Premiums.—Petitioner received prior to 1905 premiums on sales of certain of its bonds due and payable subsequent to the taxable year 1921. Held, that no portion of such premiums represented income to petitioner in 1921. Old Colony Railroad Co., 6 B. T. A.

[fol. 46] Id. Lessee's Transactions in Leased Properties.—Under the term of a 99-year lease of all of its property, petitioner granted to the lessee the right to dispose of items of the leased property no longer necessary, in the opinion of the lessee, to the use of the property, the lessee being obligated, in the case of such disposals, to replace such property before or at the expiration of the lease with other property of an equal value. The proceeds of such sales were received and retained by the lessee, and the latter made the replacements as provided. Held, that from such sales during the taxable year 1921 petitioner derived no income, their effect as to it being merely an unrealized appreciation in value of its reversion in the leased property as a whole.

Affiliation. All of petitioner's property and business was used and operated during the taxable year 1921 by its lessee under a 99-year lease, such lessee also being the owner of 44 percent of its capital stock and an additional 18.56 percent of such stock being owned or controlled by stockholders of the lessee. Approximately 38 percent of petitioner's voting stock was owned during that year by stockholders having no connection or community of interest with the lessee but who made no effort to contest the latter's control of petitioner's business and policies and such of them as participated in the stockholders' meeting of that year voluntarily gave their proxies to the lessee. Held, that the lessee did not own or control substantially all of petitioner's stock during the taxable year in question.

J. S. Y. Ivins, Esq., and Joseph D. Brady, Esq., for the petitioner.

Arthur H. Fast, Esq., for the respondent.

The taxes here in controversy are for the calendar year [fol. 47] 1921, the respondent having asserted a deficiency of $17,172.75 and the petitioner an overpayment of $156,124.42. The errors assigned are upon (a) respondent's refusal to treat petitioner as affiliated with the New York, New Haven & Hartford Railroad Co. during the taxable year, and (b) his inclusion in petitioner's taxable income for that year of amounts representing (1) an apportionment of premiums received between 1894 and 1905 on sales of its bonds; (2) Federal income taxes assessed against it but paid or payable by its lessee, and (3) amounts as representing taxable gains upon sales of certain of its capital assets by such lessee.

In his answer filed to the petition respondent charges petitioner with the receipt in 1921 of $335,500.71 of income in addition to that upon which the deficiency of $17,172.75 was computed, and asks on this basis that the deficiency be increased.

Findings of Fact

Petition is a corporation chartered under the laws of Massachusetts and with its principal office at South Station, Boston. The New York, New Haven & Hartford Railroad Co., hereinafter called the "New Haven", is a corporation organized and existing under the laws of Massachusetts, Rhode Island and Connecticut and operates a railroad system in those States and in the State of New York.

On February 15, 1893, petitioner leased its railroad lines and all other property to the New Haven for a term of 99 years from March 1, 1893. The provisions of this lease, which has been in full force and effect ever since that time, appear in full in our findings of fact in the matter of the appeal of this same petitioner in respect to its tax liability for the year 1918 (Old Colony Railroad Co., 1 B. T. A. 1067), to which reference is made, and for that reason need not here be set out.

During the calendar year 1921 the railroad and property of the petitioner were under the lease operated as a part of the railroad system of the New Haven. During all of that [fol. 48] taxable year petitioner had issued and outstanding 222,940 shares of capital stock, all of it common and voting stock. During all of that year the New Haven owned 98,132 shares of this stock. The 19 next largest stockholders

owned a total of 14,655 shares at the beginning of that year and 14,527 at the close, the largest of these 19 individual stockholdings being 4,200 shares and the next largest 1,084 shares. The balance of the stock, 110,153 shares, was owned by 4,819 different individuals and corporations, none of whom owned as many as 358 shares. In additional to the 98,132 shares owned by the New Haven, 41,390 shares, or 18.56 percent of the entire amount outstanding, were owned or controlled by 313 persons and corporations as individuals or trustees, who at the same time owned or controlled 61,757 shares of the 1,571,179 outstanding shares of stock of the New Haven.

There was but one meeting of petitioner's stockholders in 1921, this being the regular annual meeting on March 29. In calling this meeting the same procedure was followed as in preceding years and as called for by the by-laws, a notice being mailed to all holders of 75 or more shares of stock, the smaller stockholders being notified only by the regular advertisement of the meeting made in newspapers. With each notice mailed there was included a form of proxy with spaces for the names of both the attorney and the stockholder in blank. At this meeting 138,247 shares of petitioner's stock were represented and voted. This included the 98,132 shares owned by the New Haven and for which a proxy was given by it to F. S. Curtis and A. P. Russell. Of the balance of stock voted, 143 shares were represented by a proxy returned made out to F. S. Curtis and the rest was represented by 137 proxies signed and returned with the name of the attorney-in-fact left blank and which were formally completed by a clerk of petitioner by the insertion of the name of E. M. Glidden in some and the name of T. W. Hoogs in others. Some of these proxies were given by individuals included among the 313 stockholders of petitioner [fol. 49] who also owned stock of the New Haven and some by parties who had no interest in or connection with the New Haven. The said A. P. Russell was then and is now a vice-president of the New Haven and a director of petitioner. The said F. S. Curtis was then and is now the president of petitioner. He had for many years been an officer of the New Haven, resigning as vice-president in 1907 to become president of petitioner. He had prior to that time, and while he was vice-president of the New Haven, been a director of petitioner. Curtis for many years had been,

and was during 1921, president of the Union Freight Railroad, chairman of the trustees of the Boston Terminal Company, and director of the Providence, Warren & Bristol Railroad Co. All of the stock of the Union Freight Railroad was in 1921 owned or controlled by the New Haven, which also controlled 80 percent of the stock of the Boston Terminal Company, and was the lessee of the Providence, Warren and Bristol, Curtis being a director in the latter, nominated by the New Haven. The said E. M. Glidden was in 1921 treasurer of petitioner and also of the Union Freight Railroad Company, Boston Terminal Company, and Providence, Warren & Bristol Railroad Co. The said T. W. Hoogs was in that year an employee of the New Haven, in the office of its vice-president. The 138,247 shares of petitioner's stock voted at the 1921 annual meeting were voted by Curtis, Glidden and Hoogs, who were the only parties present at such meeting with exception of B. A. Powers, clerk of petitioner, and who is also employed by the Boston Terminal Company and Union Freight Railroad Company, and who prepared the ballots for election of officers. All of the stock was voted similarly for the officers elected. The procedure and result was typical of that in prior years. There was never any effort by the small stockholders to combine or oppose the control of the election by the New Haven. The directors' meetings of petitioner are held quarterly. The only business transacted at such meetings is the election of officers, declaration of dividends, and the [fol. 50] formal approval of requests made by the New Haven in respect to matters required of them under the terms of the lease agreement between petitioner and the New Haven.

A consolidated return of the New Haven and its affiliated companies for the year 1921 would show a net loss sufficient to completely absorb the net income of petitioner for that year.

The New Haven did not own or control substantially all of the stock of petitioner during 1921, nor was substantially all of the stock of those two companies owned or controlled by the same interests during that year.

During the years 1895 to 1904 petitioner issued and sold its bonds for divers amounts, receiving therefor, in addition to the face amount of such bonds, premiums aggregating $199,528.08. Such premiums were credited to a "Premium

on Bond" account and remained there undisturbed until 1914, when the Interstate Commerce Commission required the petitioner, for the purpose of its report to that Commission, to amortize such premiums over the periods of the respective lives of the bonds. For the purpose of meeting the requirements of the Interstate Commerce Commission, and over its protests to that Commission, the petitioner made such adjustments, and for each year subsequent to 1914 reported a ratable proportion of such premiums to the Commission as income. On its books in each such year petitioner credited such proportion of the premiums to profit and loss account (a surplus account) and not to its income account. The amount so credited to profit and loss account for 1921 was $6,960.64. The respondent increased petitioner's taxable income for the year 1921 by such amount of $6,960.64. The New Haven as lessee paid the entire amount of interest accruing on petitioner's funded debt in 1921, and the full amount thereof was included in the gross income shown on petitioner's 1921 return.

By virtue of the provisions of the lease agreement the [fol. 51] New Haven paid in 1922 the Federal income and profits taxes for the year 1921 upon the net income returned by petitioner for that year. The amounts of such taxes were $156,124.42 on income of $1,568,244.20 returned for 1921, and which did not include any amount paid or accrued as Federal income or profits taxes. No part of such payment has been refunded. The taxes so paid were not due or payable until on or after March 15, 1922. In determining the deficiency here appealed from respondent included in petitioner's income for 1921 the sum of the taxes so paid. Similarly in 1921 the New Haven paid the Federal income and profits taxes upon the income returned by petitioner for 1920, such taxes being due and payable in 1921. The taxes so paid amounted to $155,339.49 upon a net income of $1,555,394.85, and which did not include any amount paid or accrued as Federal income or profits taxes. No part of such payment has been refunded. No amount was included by respondent in the deficiency here appealed from on account of the payment of such 1920 taxes in 1921, but respondent now seeks to include the amount of such payment in petitioner's income of 1921, if it be held that the payment made in 1922 of 1921 taxes did not represent income to petitioner in the latter year.

In 1921 the New Haven, as lessee of petitioner, paid to or for the account of petitioner, exclusive of taxes, the sum of $2,109,257.31. This sum was at once disbursed by petitioner as follows:

Dividends	$1,560,580.00
Interest	538,920.00
Organization Expenses	9,757.31
	$2,109,257.31

These items were included in gross income by petitioner in making its return for 1921. Petitioner also included in income in that return an item of $664.20 as a net amount of taxable profit in that year from 11 transactions as sales of real estate. Respondent in determining the deficiency [fol. 52] increased this profit to $7,888.13. The 11 transactions reported were as follows:

Sales of Land

Property	Date acquired	Cost	Amt. received
East Walpole, Mass.	1891	$34.98	$50.00
Kingston, Mass.	1879	364.14	300.00
Mansfield, Mass.	1889	2,416.44	3,200.00
Wrentham, Mass.	1889	258.00	4,000.00
Boston, Mass.	1845	5,939.40	10,000.00
Boston, Mass.	1871-1874	3,219.00	5,085.30
Wareham, Mass.	1874	2,000.00	175.00
Roxbury, Mass.	1895	922.08	862.15

Dispositions Through Condemnation

Property	Date acquired	Cost	Amt. received
Quincy, Mass.	1911	$15.84	$50.00
Wareham, Mass.	1890	52.80	260.00
Boston, Mass.	1845	8,890.00	40,000.00

The first seven items listed above were sales made by the New Haven of land of petitioner and approved by petitioner's directors as provided in the lease. On all of these sales the amounts for which the property sold were received by the New Haven in 1921. The eighth item was a similar

sale made in 1919 and on which the consideration was received in that year. The ninth and tenth items were lands of petitioner taken under condemnation for public use and paid for in 1921. The last item listed was an easement belonging to petitioner and condemned by the City of Boston in 1916, and after considerable litigation a compromise was effected under which the city paid in 1921 the sum of $40,000. In the case of all of these dispositions listed the consideration paid was received from the grantees by and retained by the New Haven. The total gain of $664.20 reported by petitioner as taxable gain on these transactions was computed upon the basis of an estimated March 1, 1913, value in each case determined by the Real Estate Department of the New Haven.

[fol. 53] In carrying out operations between petitioner and the New Haven under the lease of the former's properties by the latter, the cost of all purchases of property by the lessee of additions to petitioner's property and the cost of all permanent improvements, which cost petitioner would be obligated upon demand of the lessee to reimburse it for by issue and sale of additional bonds or stock, was, upon such expenditures being made, charged to petitioner upon an open account maintained upon the books of each company. This open account with the New Haven upon petitioner's books is credited with the cost of such additions and permanent improvements and debited with the proceeds of any sales of petitioner's property made by the New Haven. This open account with petitioner on the New Haven's books is debited with cost of such additions and permanent improvements and credited with the proceeds of sales of petitioner's property. When a parcel of petitioner's real estate is disposed of by the New Haven, petitioner also credits its property account with an amount equal to its cost and either debits or credits its profit and loss account, as the case may be, with the difference between such cost and the amount paid the New Haven by the purchaser. Credits to the open account upon petitioner's books with the New Haven and representing additions and permanent improvements are also debited to petitioner's property account. Whenever the debit balance in the open account on the New Haven's books reaches an amount which, in the judgment of the officers of the New Haven, is sufficiently substantial, the petitioner, at the re-

quest of the New Haven, issues stocks or bonds, which are sold at their market value, and the proceeds paid over to the New Haven, which credits the amounts thereof to the open account with petitioner. No rights to subscribe of any value accrue to petitioner's stockholders or bondholders. The said open accounts do not carry interest.

On December 9, 1920, the New Haven placed a first and refunding mortgage on its property, including its leasehold [fol. 54] interest in the property of the petitioner. In many instances upon the receipt of the proceeds from the disposition of petitioner's real estate, the New Haven notified the Bankers Trust Company, trustee under said mortgage, that the proceeds either had been or would be applied to a specific-named improvement or addition on the line of petitioner. In all instances such proceeds were credited to the open account.

In 1895 petitioner acquired a tract of 731 acres at Squantum (Quincy), Mass., at a cost of $206,016.29. On October 6, 1917, the President, under authority of the Act of Congress, approved on that date, 40 Stat. 345, 371, condemned and took over for immediate use for national defense purposes the title and possession of such land and under the provisions of that act determined the amount of just compensation to be paid therefor to be $400,000. The petitioner and the New Haven were not satisfied with this amount and, as permitted by the provisions of that act, elected to receive 75 per centum of the amount of the award by the President or $300,000 and to bring suit in the Court of Claims to recover of the United States the difference between this sum and such amount as would be found by the court to be just compensation for the property taken.

On or about May 22, 1918, the United States paid to petitioner and the New Haven the $300,000 elected to be received in partial payment. On January 18, 1919, this sum of $300,000 was credited to petitioner by the New Haven upon the open account heretofore mentioned.

On February 5, 1919, petitioner and the New Haven brought suit in the Court of Claims to recover of the United States the additional amount claimed as just compensation for the Squantum property. In this suit the court found upon stipulation of the parties that the reasonable value of the property taken was $575,000, and on May

31, 1921, entered judgment for $275,000, which sum was received by the New Haven in February, 1922, and thereupon credited to petitioner by the New Haven upon the [fol. 55] aforementioned open account. Petitioner accounted for this transaction on its books in 1922 by crediting its profit and loss account with the sum of $335,590.70, said sum being the difference between $575,000 and the cost of the property plus expenses incident to the recovery of that amount. Petitioner computed a gain on this disposition of real property of $99,434.39, and reported this on its return for 1922, and respondent upon examination of that return increased such profit to $335,500.71 and now contends that such profit represents income for 1921. Petitioner has at all times kept its accounts upon an accrual basis.

OPINION

TRUSSELL:

Two of the issues raised by petitioner need little discussion as they each involve a question which has been heretofore presented to us and decided upon facts similar to those here involved. One of these issues is the so-called "tax" on "tax" question, or whether payments of Federal income taxes by the lessee for account of the lessor, as required by the terms of the lease, constitute additional income to the lessor. That such payments represent additional taxable income was held by the Supreme Court in Old Colony Trust Company et al., Executors, v. Commissioner of Internal Revenue and United States v. Boston & Maine Railroad Company, both decided June 3, 1929, and we accordingly have for determination here the question of what income of this character received by petitioner constitutes income for the calendar year 1921. Respondent in determining the deficiency has included the amount of Federal taxes in respect of income for that year and which were due and payable in 1922 and paid in that year by the New Haven, but asks, in the event that such taxes are held not to represent income for 1921, that the deficiency be redetermined by including in petitioner's income the sum of $155,339.49 income and profits taxes of petitioner for 1920, due and paid by the New Haven in 1921 for account of petitioner. We

held that the Commissioner was in error in including in [fol. 56] income for 1921 the amount of Federal taxes for that year not due or payable and not paid until 1922. Norwich & Worcester Railroad Co., 2 B. T. A. 215; United States v. Norwich & Worcester Railroad Co., 16 Fed. (2d) 944. We further hold that the $155,339.49 of Federal income and profits taxes of petitioner for the calendar year 1920 due and payable in 1921 and paid in that year by the New Haven for account of petitioner represents additional income in that amount to the latter for 1921. Providence & Worcester Railroad Co., 5 B. T. A. 1186; Old Colony Trust Company et al., Executors, 7 B. T. A. 648; Houston Belt & Terminal Railroad Co., 6 B. T. A. 1364.

The second issue is upon respondent's inclusion in petitioner's income for 1921 of a proportionate amount of the premiums received by it prior to 1905 on sales of its bonds which are not yet due and payable, respondent having prorated such premium over the life of the bonds and allocated $6,960.64 thereof to income for that year. In Old Colony Railroad Co., 6 B. T. A. 1025, this same question was presented with respect to this petitioner's tax liability for 1920 and we held that respondent's action in prorating the amount of such premiums as income of current years during the bond period was in error and this error was affirmed by the Circuit Court of Appeals, 26 Fed. (2d) 408. Under authority of that decision we held that no part of the premiums in question represented income to petitioner in 1921.

This brings us to consideration, in the light of facts here proven, of the question of whether petitioner was affiliated with the New Haven in 1921. The question is a vital one in this proceeding, as it is admitted by stipulation that the New Haven sustained a net loss in this taxable year sufficient to absorb any net income found as received by petitioner and if it be found that affiliation as defined in section 240 (c) of the Revenue Act of 1921 existed, the result would wipe out the liability not only for the deficiency determined [fol. 57] but for the tax already paid for that year. The section in question reads as follows:

(c) For the purposes of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely

affiliated interests or by a nominee or nominees substantially all the stock of the other or others or (2) is substantially all the stock of two or more corporations is owned or controlled by the same interests.

In Old Colony Railroad Co., 1 B. T. A. 1067, this same petitioner, for the year 1918, upon proof of the same facts as shown herein as to operation of its railroad and properties under this same lease and the ownership during that year by the New Haven of 98,122 shares of its stock, claimed affiliation with the New Haven and we held this proof insufficient to show "ownership or control of substantially all" of its stock by the New Haven and denied the claim of affiliation. However, the claim is here asserted as to a different year and is to be determined upon the proof adduced as to conditions existing in that year. We have no reason to question the correctness of the conclusion reached by us upon the proof submitted in the former case cited and in no facts in addition to those proved in that case are shown as to the year here in question we would hold that no affiliation existed. Petitioner, however, attempts to meet the situation by proving additional facts which it contends, when considered with the facts proven in the former case, and which are also proven on the present proceeding as existing in the taxable year now before us show, that the New Haven controlled substantially all the stock of petitioner in that year.

An examination of the facts found in the former proceeding and the evidence submitted in the present case show that similar conditions existed in the two years with respect to operation of petitioner's properties by the New Haven under the lease in question and the ownership by the [fol. 58] latter of 44 percent of petitioner's outstanding stock, it being the largest individual stockholder, the next largest stockholder owning 4,200 shares. In the former year it was shown that the 18 next largest stockholders owned a total of 10,521 shares and the balance of petitioner's 222,940 shares of stock outstanding was owned by 4,666 stockholders, none of whom owned individually more than 400 shares. In the present proceeding it is shown that the 18 next largest stockholders owned at the beginning of the year a total of 10,455, at the close a total of 10,327 shares, and that the balance of petitioner's outstanding

stock, which was the same as in the former year, was held by 4,819 stockholders, none of whom owned as many as 358 shares.

It will thus be seen that up to this point the proof as to the conditions existing in 1918 and 1921 are for all practical purposes the same and it is this proof which we held in the former proceeding as insufficient to show control by the New Haven of substantially all of petitioner's stock. However, petitioner, for the year before us presents additional proof, this being that during that year, in addition to the 98,132 shares, or 44 percent of petitioner's stock owned by the New Haven, 41,390 shares, or 18.56 percent was owned by 313 individuals, partnerships and corporations who, at the same time, owned or controlled 61,757 of the 1,571,179 shares of outstanding stock of the New Haven; that these stockholders usually gave their proxies to the representative of the New Haven in the stockholders' meetings; and that in the taxable year in question of the stock represented and voting at the annual stockholders' meeting, or 138,247 shares, was voted under proxy by three individuals who represented the New Haven interests, those proxies having in fact been given the New Haven.

It is insisted that these facts when considered with the others showing control of petitioner's properties under the lease and the absolute ownership by the New Haven of 44 percent of its stock and the wide distribution of the stockholdings in small individual amounts, are sufficient to prove [fol. 59] an actual control of substantially all of that stock by the New Haven.

With this view we cannot agree. At the most such proof would only indicate ownership and control through affiliated interests of 62.56 per cent of petitioner's stock even were we to consider that the New Haven controlled the additional 18.56 per cent of petitioner's stock by reason of the fact that it was owned by certain of its stockholders. However, the New Haven's stockholders, who were also stockholders of petitioner, owned only 61,757 or less than 4 per cent of the 1,571,179 shares outstanding of the New Haven's stock and the individual owners are not shown to have been connected with the New Haven in any way other than as owners of this comparatively small amount of its stock. No circumstances are shown which indicate a control by the New Haven of the stock owned by these indi-

viduals and the fact that in the annual stockholders' meeting for the taxable year some of those and certain other stockholders of petitioner gave to the New Haven's representative proxies to vote their stock does not indicate that such action was or could have been required of them. In petitioner's annual stockholders' meeting in 1921, there were 138,247 shares of stock voted, all of this being represented by proxies in the hands of the New Haven's representatives, 98,132 shares being the stock owned by the New Haven and the balance being the holdings of 138 small stockholders, some of them stockholders of the New Haven. The record shows nothing to indicate that the proxies of these 138 stockholders were given other than voluntarily, and the fact that in that year, and possibly in prior years, these proxies were voluntarily given, indicates an acquiescence and approval by these stockholders, in those years, of the control exercised by the New Haven of the organization of petitioner, but not control by it of the voting rights of the stock, which we have held is the "control" referred to in the statute. Isse Koch & Co., 1 B. T. A. 624. It will be also noted that almost 38 per cent of the outstanding stock [fol. 60] of petitioner during this year was owned by stockholders who had no manner of connection or community of interest with the New Haven.

In Ice Service Co., Inc., 9 B. T. A. 386, we held that a taxpayer owning approximately 68 per cent of the stock of another company which owed it large sums, whose notes were endorsed by it and whose business was completely controlled and dominated by the taxpayer through officers and directors elected by it, was not affiliated with such company in contemplation of section 240 (c) of the Revenue Act of 1921. In this case, in holding that the ownership of approximately 32 per cent of the stock by minority stockholders who had no connection with petitioner, and who retained the voting rights on their stock, precluded a claim of affiliation, we said of the minority stockholder:

* * * He still has the right to vote his stock and thus oppose the wishes of the majority if he so desires. True, the votes of the minority will not determine the policies of the corporation when the majority of the voting shares is held by one individual or corporation, but such control of the policies and financial affairs of the corporation as an entity does not amount to control of the individual stock-

holder or his stock. There must be a control of the voting rights. Appeal of Canyon Lumber Co., 1 B. T. A. 437; Adaskin-Tilley Furniture Co. v. Commissioner, 6 B. T. A. 316.

The Circuit Court of Appeals for the Second Circuit in approving the conclusion reached and affirming this decision, on appeal, Ice Service Co., Inc. v. Commissioner of Internal Revenue, 30 Fed. (2d) 230, said:

* * * The theory of affiliation, resulting in a consolidated return for taxes, is that the income and invested capital are really the income and capital of a single enterprise, though carried on through the instrumentality of several corporations. See article 631, Treasury Regula-
[fol. 61] tions (1920 Ed.) Holmes, Fed. Taxes (6th Ed.) 281; Alameda Inv. Co. v. McLaughlin, 38 F. (2d) 81 (D. C. N. D. Cal.). Only when the outside interest—that is, the interest of the minority—is so small as to be practically negligible, are the two corporations to be treated as in receipt of a single income, requiring a consolidated return.

It is undoubtedly true that under the terms of the lease in question, executed long prior to the income-taxing statutes, all of the obligations of both corporations of every character fall ultimately upon the New Haven and the income of both is produced by the New Haven in the operation of its owned and leased properties, and from an economic standpoint it may well be argued that for taxing purposes the income of both should be considered as one, but with that question we are not concerned. The two corporations are distinct entities and we may only construe and apply the law as enacted, and this provides the basis for affiliation, and the right to file a consolidated return, as ownership or control of substantially all of the stock. We hold that petitioner was not affiliated with the New Haven during the taxable year in question.

The last issue is upon respondent's action in including in petitioner's income various amounts representing in each case the difference between the cost of and amount received by the New Haven for leased properties of petitioner, sold by the lessee under authority of the lease, or taken by condemnation by Governmental authority.

The lease permits the New Haven to sell items of land and improvements from time to time when deemed by it

advisable. The proceeds of such sales are retained by it and the only obligation upon it is to replace such property sold with other property of an equal value. No increase in the rental is caused by such replacement. The New Haven also makes from time to time what in its judgment are necessary capital additions or improvements to the leased [fol. 62] property, advancing the funds therefor, and petitioner is required by the lease to issue bonds or stock when called upon by the New Haven, which are sold and the proceeds used to reimburse the latter for the advances made. The New Haven, in the case of such issue of stock or bonds, pays from that time forward an increased rental by reason of its obligation to pay all bond interest and $7 a share on all outstanding stock. Petitioner and the New Haven each carry an account on its books of the advances made by the latter for additions and improvements. This account usually represents a large amount and when, in the opinion of the New Haven, it reaches a sum justifying or calling for an issue of stock or bonds, the call for such issue is made. However, in the meantime the New Haven is from year to year making casual sales of items of the leased property which it deems are no longer needed and the practice has consistently been to credit the proceeds of such sales to this account of advances for additions and betterments, thus reducing to this extent the sum for which additional stock or bonds would be issued at some time in the future. It follows, we think, that from the date of the credit given by the New Haven and taken by petitioner the proceeds of such sales are represented by capital additions and improvements and that upon giving such credit the New Haven has complied with its lease obligation to replace such property sold with property of a similar value. The giving and taking of the credit against the accounts of advances shows that the parties have consistently considered such to have been the result. Petitioner has in each case, upon taking such credit against the New Haven account on its books, charged the difference between the cost of the property sold and the price realized to profit and loss, as a gain or loss, depending upon whether cost was below or above the price realized, and has carried such adjustment to its capital asset accounts.

Petitioner contends that in none of these sales, whether voluntary or by condemnation, is a profit or loss realized

[fol. 63] which may be reflected in its income in 1921, as such transactions, as to petitioner, represent not sales but exchanges of property falling within the exception provided by section 202 (c) of the Revenue Act of 1921, providing:

(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized.

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use; * * *

With respect to the items of gain included as pertaining to the condemnation of an easement by the City of Boston, and the taking of real estate by condemnation exercised by the Federal Government, petitioner contends that, it being on an accrual basis, in neither case, even though it should be found that the transactions were ones on which it realized taxable profits, were such profits income in the year 1921, but pertained to the year in which the properties were taken irrespective of the period in which the amount of compensation to be paid for the taking was determined, or the year in which such compensation was paid. It further contends with respect to the last mentioned item that the United States can not constitutionally reduce by taxation just compensation paid for property which it has taken.

In respect to the proceeds realized from the conversions under condemnation proceedings, and which constitute almost all of the amount in controversy under this issue, it is noted that the facts proven show that the entire amount realized in each instance was applied by the lessee to the cost of capital additions and improvements to petitioner's [fol. 64] property and this amount was, from the date received, represented by such capital additions. Section 234 (a) (14) of the Revenue Act of 1921 provides:

If property is compulsorily or involuntarily converted into cash or its equivalent as a result of * * * (c) an

exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, * * * or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. * * *

Even though it should be concluded that these involuntary conversions resulted in a realization of taxable gain to petitioner, the immediate disposition of the entire proceeds of the sale by investment in property which is undoubtedly "of a character similar or related in service or use to the property so converted" would entitle petitioner to a deduction representing the entire amount of the gain realized, resulting in the elimination from its net taxable income of all of such gain.

However, the first question raised by petitioner, that all of the conversions are in fact, as to petitioner, exchanges of property and not sales, affects the entire amount. If petitioner is correct in this contention, no portion of the sale price received by the New Haven for these transfers of petitioner's properties can be included in petitioner's income.

Upon consideration of this question it appears to us unnecessary to pass upon the question of whether these transactions are ones falling within the provisions of section 202 (c) of the Revenue Act of 1921. Even if not ex- [fol. 65] changes of property for property of a like kind or use, the circumstances in our opinion show them to be transactions from which petitioner has derived no income.

The provisions of the lease in question show clearly that, as one of the considerations moving to it in return for the rental paid, the New Haven possesses the right to dispose of items of the leased property, whereupon it becomes obligated to replace them with similar property of an equal value. As a necessary incident of the exercise of this right by the New Haven it is provided that petitioner will at its request execute, through its officers, the necessary con-

veyances. The consideration paid by the purchaser secured by the New Haven is retained by the latter. The result to petitioner of the conversion is known and determined before the conveyance is made, this being that it will stand possessed of other assets of a character or use similar, and a value equal, to those conveyed. As we view those transactions the New Haven does not dispose of those items of property merely as an agent of petitioner but by its right acquired under the lease contract,—a right bought and paid for in the rental reserved. It does not receive the payments made for these properties as agent for petitioner, but in its own right as funds to which it has right and title, subject merely to its obligations to convey to petitioner similar property of an equal value to that which it has sold.

Respondent insists in effect that a disposition of property under the lease provision constituted two distinct and separate transactions; first, a sale and transfer of the property by petitioner through the New Haven as its agent, for a sum of money, and the receipt of the sum by the New Haven as such agent, and second, the investment of these proceeds of sale by petitioner, through its agent, in other property.

With this we do not agree. Petitioner has for a stated rental granted the New Haven the use of its properties for 99 years, and has given it the right to dispose of such items of property during that period as it deems to have [fol. 66] become unnecessary to the property as a whole and replace such items by ones of a similar value and for which a necessity exists. Does the fact that, during the course of the transaction under which such items of property are disposed of and replaced, the various steps and final result of which in each case are fixed and determined before the first step is taken, certain sums of money come into the hands of the New Haven, make such sums income to petitioner when it does not receive them and has no control over or disposition of them? In this connection it must be remembered that the use of these funds by the New Haven is in the discharge of its own obligation to replace the property conveyed.

We cannot agree with respondent that the several steps of this transaction constitute separate transactions, and that upon conveyance of the property by petitioner and

the receipt of the purchase price by the New Haven under the sale it has negotiated, the transaction is a closed one as to petitioner, who thereupon, for income tax purposes, is in receipt of the consideration paid. Compare United States v. Mollon, 279 Fed. 910 (aff. 281 Fed. 645). As we can see it petitioner has not then received its consideration, which is the property to be conveyed to it to replace that taken. It cannot be, in our opinion, charged with receipt of income in respect to the payment. At no time can it exercise an option by cancellation of the lease, and, instead of the replacement property, take the proceeds of the sale.

The court in Eisner v. Macomber, 252 U. S. 189, defines income as "not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived', that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal". We cannot see that petitioner, as a result of these disposals of property, has received anything meeting this definition.

[fol. 67] The effect of those transactions, insofar as petitioner is concerned, can be at the most merely an appreciation in value of petitioner's reversion, an unrealized capital gain, by reason of the fact that the leased property as a whole is rendered more usable and consequently of greater value to the lessee and such value may possibly be maintained beyond the lease term. To consider them sales of property by petitioner, and the proceeds as gross income to petitioner, is to overlook the fact, not only that the proceeds were received and used by the New Haven with no obligation upon its part except to replace the property at the expiration of the lease period of 99 years, but the fact that the property conveyed represents both the reversion of petitioner in such property and the leasehold interest therein belonging to the New Haven—its right to use for a remaining period of more than 70 years, which right would have a present value many times that of the reversion. Petitioner's participation in or use and enjoyment of any gain realized is necessarily postponed until the termination of the lease. It receives no increased rental by reason of the transactions.

The conclusion reached makes it unnecessary to pass upon the other questions raised by petitioner under this issue.

Reviewed by the Board.

Judgment will be entered pursuant to Rule 50.

Rundell dissents on the third point.

Now, November 18, 1930, the foregoing Findings of Fact and Opinion certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

A true copy. Teste:

B. D. Gamble, Clerk U. S. Board of Tax Appeals.

[MEMORANDUM—Certified copy of lease is here omitted as it is already printed at pages 18 to 25, inclusive. A. I. Charron, Clerk.]

[fol. 68] BEFORE U. S. BOARD OF TAX APPEALS

NOTICE OF SETTLEMENT—Filed November 22, 1929

The following proposed settlement of the deficiency in the above-entitled case will be presented to the Board on ——, ——, at 9.30 a. m.:

Net income shown by deficiency notice		$1,732,971.65
Deduct items included in net income by respondent disallowed by Board:		
(1) Bond premium	$6,960.64	
(2) Profit on sales of real estate	7,888.13	
(3) Federal income taxes for 1921	157,542.88	
		172,391.65
Balance		$1,560,580.00
Add items to be included under Board's decision:		
(1) Federal income taxes for 1920 paid by lessee in 1921		155,339.49
Corrected net income		$1,715,919.49

Computation of Tax

Net income, $1,715,919.49—Taxable at 10%	171,591.95
Previously assessed	156,124.42
Deficiency	$15,467.53

This notice of proposed determination is submitted in accordance with the decision of the Board without prejudice to the petitioner's right to contest the correctness of the decision pursuant to the statute in such cases made and provided.

J. S. Y. Ivins, Counsel for Petitioner.

% Holmes, Brewster & Ivins, 815 Fifteenth Street, N. W., Washington, D .C.

[fol. 69] Now, November 18, 1930, the foregoing Notice of Settlement certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

Before U. S. Board of Tax Appeals

Order of Redetermination—Entered December 16, 1929

The above-entitled action came on for hearing on December 11, 1929, upon motion made on behalf of the petitioner for an order of final settlement of deficiency accompanied by a proposed recomputation thereof. There was no appearance in support of the motion on behalf of the petitioner. Arthur H. Murray, Esq., appeared on behalf of the respondent and made no objection to the form and amount of settlement as proposed by petitioner's counsel. Upon consideration of the proposed recomputation of the deficiency as proposed by petitioner's counsel it appears that the said recomputation is in all respects in accord with the findings of fact and conclusions of law promulgated on November 19, 1929. Now, therefore, upon consideration of the name and of all the records and files in this action, it is

Ordered, Adjudged, and Determined, that for the calendar year 1921 the deficiency is $15,467.53.

Enter.

Sumner L. Trussell, Member United States Board of Tax Appeals.

Washington, —— —, ——.

Now, November 18, 1930, the foregoing Order of Redetermination certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals. (Seal.)

A true copy. Teste:

B. D. Gamble, Clerk U. S. Board of Tax Appeals.

[fol. 70] BEFORE U. S. BOARD OF TAX APPEALS

MOTION FOR RECONSIDERATION—Filed January 28, 1930

Now comes the respondent, the Commissioner of Internal Revenue, in the above-entitled cause, by C. M. Charest, General Counsel, Bureau of Internal Revenue, and moves that the Board reopen said cause in so far as it relates to bond premiums referred to in the second paragraph of the headnote of the decision of the Board promulgated November 29, 1929, and to reconsider the correctness of said decision for the following reason:

The opinion of the Board was based upon the same theory of law as that passed upon by it in the case of Old Colony Railroad Company v. Commissioner, Docket No. 7820, 6 B. T. A. 1025, which case involved the question of whether or not the amortized amount of bond premiums received prior to January 1, 1909, applicable to the year 1920, was income in said year 1920, whereas the facts presented in the present proceeding present the additional issue of whether or not said amortized portion of said bond premiums should not be given consideration in determining the interest deduction of the taxpayer for the purpose of determining its net taxable income. Said latter issue was not considered by the Board in its present decision.

The respondent further moves that the Board amend its findings of fact in relation to said bond premiums to in-

corporate in said findings of fact certain evidence presented by the respondent at the hearing and certain allegations of fact set forth in the petitioner's petition, admitted by the respondent in his answer, said additional findings of fact to consist of the following:

The petitioner in its income tax return for the year 1921 claimed as a deduction from gross income the sum of $538,920 as interest paid by the petitioner on the bonds issued between 1895 and 1904 on which premiums an aggregate of [fol. 71] $199,528.08 had been received at the time of sale. Said interest deduction of $538,920 represented the entire interest paid by the New Haven to the bondholders of the petitioner without any reduction to represent any portion of the amortization of the bond premiums received at the time said bonds were originally sold. Said deduction of $538,920 claimed by the petitioner in its income tax return for the calendar year 1921 was allowed in full by the respondent in determining the taxable income of the petitioner set forth in the deficiency letter, which was the basis of the petitioner's appeal to the Board.

Wherefore, the respondent prays that the Board will set aside and revoke its final order dated December 16, 1929, in the above-entitled cause, will reopen such portion of said cause as relates to bond premiums for the purpose of giving further consideration to the correctness of the deductions allowed by the Commissioner in determining the petitioner's net taxable income as shown in the deficiency letter and for the purpose of amending its previous findings of fact relative to the deduction of interest claimed by the petitioner in its income tax return and allowed by the Commissioner in his final determination of the petitioner's tax liability for the year 1921.

C. M. Charest, General Counsel, Bureau of Internal Revenue. Of Counsel: L. A. Norman, J. W. Wideman, Special Attorneys, Bureau of Internal Revenue.

1/27/30.

Now, November 18, 1930, the foregoing Motion certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

[fol. 72] BEFORE U. S. BOARD OF TAX APPEALS

JOINT MOTION FOR RESCISSION OF FINAL ORDER—Filed and Granted May 24, 1930

The parties desiring to join in a request to the Board that it make additional findings of fact in this case, and it being desirable that the Board have opportunity to consider such additional findings in passing upon the respondent's motion (filed January 28, 1930) for reargument and reconsideration, counsel for both parties hereby respectfully

Jointly move that the Board vacate and set aside the order of redetermination entered herein on December 16, 1929, and hold the case for further proceedings under the joint request to be filed for additional findings of fact and on the respondent's said motion of January 28, 1930.

J. S. Y. Ivins, Counsel for Petitioner. C. M. Charest, General Counsel, Bureau for Internal Revenue, for Respondent.

May 23, 1930.

Now, November 18, 1930, the foregoing Motion certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

STIPULATION—Filed June 11, 1930

It is hereby stipulated that the Board be requested to make the following additional finding of fact in this proceeding:

"During the year 1921 the New Haven paid to the bondholders of the petitioner the sum of $538,920.00 as interest on the bonds of the petitioner issued and sold between 1895 and 1904. Said bonds were the direct obligation of the petitioner to the owners of said bonds, and no agreement has [fol. 73] ever been executed between the petitioner and said bondholders releasing the petitioner from such direct lia-

bility to said bondholders on any of said bonds. In its income tax return for the year 1921, petitioner included this sum of $538,920.00 as an item of gross income and also took a deduction of the same sum of $538,920.00 from gross income as interest paid during the year. The Commissioner, in auditing petitioner's return for 1921, made no adjustment with respect to either such inclusion of $538,920.00 in gross income or such deduction of $538,920.00 therefrom, except by increasing petitioner's taxable income for the year by including therein the sum of $6,960.64, which is the amortized proportion for the year 1921 of the premiums received by the petitioner upon the sale of said bonds.

"Interest on the bonds sold at a premium between 1895 and 1904 was provided for by the following phraseology contained in said bonds. On coupon bonds:

'For value received the Old Colony Railroad Company promises to pay to the bearer hereof, or, in case of registration, to the registered holder, on the first day of December A. D. 1925, the sum of One Thousand Dollars ($1000) at the office of its Treasurer in the City of Boston, together with interest thereon at the rate of four per cent per annum, payable on the first days of June and December in each year on the presentation and surrender of the annexed coupons as they severally become due, said coupons to be paid to the bearer hereof whether this bond is registered or not, and the company may, but shall not be obliged to, require proof of ownership of any coupon before paying the same and payment thereof to the person presenting the same shall in any case discharge the company.'

"The form of coupon attached to said bonds was as follows:

[fol. 74] 'On the first day of June 1896, the Old Colony Railroad Company will pay to the bearer at the office of its Treasurer in the City of Boston, Twenty Dollars, being six months interest on its bond No. 0000.'

"On registered bonds:

'For value received the Old Colony Railroad Company promises to pay to —— —— Five Thousand Dollars on the first day of July A. D. 1932 at the office of its Treasurer

in the City of Boston, together with interest thereon at the rate of 3½ per cent per annum, payable at said office on the first days of January and July in each year to the registered owner of his order.'

"This phraseology, except for dates and accounts, was contained in all the bonds sold at a premium between 1895 and 1904."

J. S. Y. Ivins, Counsel for the Petitioner. C. M. Charest, General Counsel, Bureau of Internal Revenue.

So ordered June 11, 1930.

United States Board of Tax Appeals, by Charles P. Smith, Member.

LAN/ESK.

Now, November 18, 1930, the foregoing Stipulation certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals. (Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

ORDER DENYING MOTION FOR RECONSIDERATION AND REINSTATING FINAL DETERMINATION—Entered June 19, 1930

The Board having entered its final order of redetermination herein, determining the deficiency in income and profits taxes of the petitioner for the year 1921 to be $15,467.53, such order having been entered on December 16, 1929; and [fol. 75] the respondent having filed a motion on January 28, 1930 for additional findings of fact and reconsideration of the issues, and L. A. Norman, Esq., for the respondent, in support of said motion, and J. S. Y. Ivins, Esq., for the petitioner, in opposition thereto, having been heard before Summer L. Trussell, member, at his chambers in Washington, on February 11, 1930, and the parties hereto having filed a joint motion for rescission of the final order of December 16, 1929 to permit amendment of the findings of fact, and said motion having been granted on May 24,

1930; and the findings of fact having been amended by the Board on June 11, 1930, in accordance with a stipulation and joint request of the parties, and due consideration having been had on the respondent's said motion for amendment of the findings and for reconsideration of the issues, filed January 28, 1930, such consideration being in the light of the findings as amended on June 11, 1930, as well as on all prior proceedings in this case, it is hereby

Ordered that respondent's said motion for amendment of the findings be denied, except in so far as the findings have already been amended by the action taken on June 11, 1930; and it is

Further ordered that said motion in so far as it requests reconsideration of the issues herein is hereby denied; and it is

Further ordered that the order of redetermination originally entered on December 16, 1929 and vacated by the order of May 24, 1930 be reinstated and restored as of this date.

Sumner L. Trussell, Member U. S. Board of Tax Appeals.

Now, November 18, 1930, the foregoing Order certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

A true copy. Teste:
B. D. Gamble, Clerk U. S. Board of Tax Appeals.

[fol. 76] BEFORE U. S. BOARD OF TAX APPEALS

PETITION FOR REVIEW TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT—Filed September 29, 1930

To the Honorable the Judges of the United States Circuit Court of Appeals for the First Circuit:

Now comes David Burnet, Commissioner of Internal Revenue, by his attorneys, G. A. Youngquist, Assistant Attorney General, C. M. Charest, General Counsel, Bureau

of Internal Revenue, and L. A. Norman, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I. Your petitioner on review (hereinafter referred to as the Commissioner) is the duly appointed, qualified, and acting Commissioner of Internal Revenue of the United States, holding his office by virtue of the laws of the United States. Your respondent on review (hereinafter referred to as the taxpayer) is a corporation organized and existing under and by virtue of the laws of the Commonwealth of Massachusetts, with its principal office at Boston, Massachusetts. Taxpayer's income tax return for the calendar year 1921 was filed with the Collector of Internal Revenue for the District of Massachusetts, whose office was located in the City of Boston, State of Massachusetts, and within the judicial circuit of the United States Circuit Court of Appeals for the First Circuit.

II. The Commissioner determined a deficiency in income taxes for the year 1921 in the amount of $17,172.75, and on May 29, 1926, in accordance with the provisions of Section 274 of the Revenue Act of 1926 sent to the taxpayer by registered mail a notice of said deficiency. Thereafter, the taxpayer filed an appeal from the said notice of deficiency with the United States Board of Tax Appeals. The first hearing on said appeal by the said Board of Tax Appeals was held on August 3, 1928, which date is subsequent to the [fol. 77] Revenue Act of 1926. On November 19, 1929, the Board of Tax Appeals promulgated its findings of fact and opinion, and on December 16, 1929, entered its judgment and an order of redetermination in said appeal wherein and whereby the Board ordered and decided the amount of deficiency against the taxpayer for the calendar year 1921 to be $15,467.53. On January 28, 1930, the Commissioner filed a motion with the Board of Tax Appeals praying that said Board revise its findings of fact to include certain evidence presented at the hearing before said Board relating to the fact that the taxpayer in its income tax return had claimed a deduction from its gross income in the sum of $538,920 as interest paid by the taxpayer on certain bonds sold by the taxpayer between 1895 and 1904 on which premiums in the sum of $199,528.08 had been received at the time of sale, and that said claimed deduction of interest had been allowed by the Commissioner in his final determination of the taxpayer's tax liability for said year 1921.

On February 11, 1930, said motion was argued before Hon. Sumner L. Trussell, member of said Board of Tax Appeals. On June 11, 1930, said Board of Tax Appeals amended said findings of fact as moved by the Commissioner and in accordance with a stipulation entered into between the petitioner on review and the respondent on review, but refused to amend or revise its opinion as to the amount of the deficiency against the taxpayer for the calendar year 1921, and on June 19, 1930 re-entered its final order of redetermination as of said June 19, 1930.

III. Nature of controversy: That part of the deficiency, to wit, $696.06, which was in controversy before the Board of Tax Appeals resulted from the determination of the Commissioner that there should be included in the taxpayer's taxable net income for the calendar year 1921 a ratable portion of the premiums received by the taxpayer upon the issuance and sale in prior years of its bonds, such ratable proportion being determined by amortizing such [fol. 78] premiums over the periods of the respective lives of the bonds.

During the years 1895 to 1904, inclusive, the taxpayer issued and sold its bonds for divers amounts, receiving therefor, in addition to the face amount of such bonds, premiums aggregating $199,528.08. The taxpayer has been required by the Interstate Commerce Commission to amortize the said premiums over the periods of the respective lives of the bonds, and to report to the said Commission a ratable portion thereof as income each year. The taxpayer did not, however, report such amounts as income for the purposes of the federal income tax nor reduce the amount of the interest paid in connection with said bonds and claimed as a deduction from its gross income in the determination of its taxable income for the calendar year 1921. The taxpayer's accounts were kept upon the accrual basis. The amount of the ratable proportion of premiums for 1921 was $6,960.64, and this amount the Commissioner of Internal Revenue included in his determination of the taxpayer's taxable net income, and thereupon determined a deficiency for that year. From this determination the taxpayer appealed to the Board of Tax Appeals. The Board held that the Commissioner erred in treating the amount in question as income for the calendar year 1921, and in further denying Commissioner's contention that the same

should be used as a reduction of the amount of interest allowable as a deduction from the taxpayer's gross income in the determination of its taxable income for the year 1921.

IV. The Commissioner says that in the record and proceedings before the Board of Tax Appeals and in the decision and final order of redetermination rendered and entered by the Board of Tax Appeals manifest error occurred and intervened to the prejudice of the Commissioner, and the Commissioner assigns the following errors, and each of them, which, he avers, occurred in the said record, proceedings, decision and final order of redetermi-
[fol. 79] nation and upon which he relies to reverse the said decision and final order of redetermination so rendered and entered by the Board of Tax Appeals, to wit:

1. The Board of Tax Appeals erred as a matter of law in holding that the pro rata portion of the premiums aggregating $199,528.08, which were applicable to the year 1921 in the amount of $6,960.64, should not properly be deducted from the amount of interest allowed to the taxpayer as a deduction from its gross income in the determination of its taxable income for said year 1921.

2. The Board erred in holding that amortization of the bond premiums in question was not required in the computation of the taxpayer's net taxable income for the year 1921.

3. The Board erred in not sustaining that portion of the deficiency in tax for the year 1921 relating to the amortization of the bond premiums in question as determined by the Commissioner.

G. A. Youngquist, Assistant Attorney General. C. M. Charest, General Counsel, Bureau of Internal Revenue. L. A. Narman, Special Attorney, Bureau of Internal Revenue.

Duly sworn to by C. M. Charest. Jurat omitted in printing.

[fol. 80] Notice

To J. S. Y. Ivins, Esq., 315 15th Street N. W., Washington, D. C., attorney for respondent on review:

Notice is hereby given to you that the Commisioner of Internal Revenue, petitioner on review in the above-entitled proceeding, did on the twenty-ninth day of September, 1930, file with the United States Board of Tax Appeals, at Washington, D. C., a petition for review of the Board's decision by the United States Circuit Court of Appeals for the First Circuit, a copy of which said petition for review as filed is herewith served upon you.

C. M. Charest, General Counsel, Bureau of Internal Revenue.

Service of the foregoing notice and of a copy of the petition for review mentioned in said notice is acknowledged this thirtieth day of September, 1930.

J. S. Y. Ivins, Attorney for Respondent on Review.

Now, November 18, 1930, the foregoing Petition for Review and Notice of filing certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals. (Seal.)

[fol. 81] BEFORE U. S. BOARD OF TAX APPEALS

PRÆCIPE—Filed October 9, 1930

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver to the clerk of the United States Circuit Court of Appeals for the First Circuit, copies, duly certified as correct, of the following documents and records in the above-entitled cause in connection with the petition for review by the said United States Circuit Court of Appeals for the First Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries of proceedings before the Board.
2. Petition filed with the Board on July 23, 1926.
3. Commissioner's answer filed with the Board on September 21, 1926.
4. "Motion for Permission to File Amended Petition" filed with the Board on July 25, 1928 and order granting the same entered on the same date.

5. Amended petition filed with the Board on July 25, 1928.

6. Answer to amended petition filed with the Board on July 25, 1928.

7. "Motion for Severance of Issues and Limitation of Hearing to Certain Issues" filed with the Board on August 3, 1928 and order granting the same entered upon the same date.

8. "Findings of Fact and Opinion" promulgated November 19, 1929.

9. "Notice of Settlement" filed by the petitioner with the Board on November 22, 1929.

10. "Order of Redetermination" entered by the Board on December 16, 1929.

11. Motion filed by the Commissioner of Internal Revenue on January 28, 1930.

12. "Joint Motion for Rescission of Final Order", filed [fol. 82] with the Board on May 24, 1930, and order granting the same entered on the same date.

13. Stipulation filed with the Board on June 11, 1930 and order entered pursuant thereto upon the same date.

14. Order denying motion for reconsideration and reinstating final determination entered June 19, 1930.

15. "Petition for Review", filed with the Board on September 29, 1930, together with Notice of Filing Petition for Review and acknowledgment of service thereon filed with the Board on October 1, 1930.

16. This Præcipe.

C. M. Charest, General Counsel, Bureau of Internal Revenue.

Now, November 18, 1930, the foregoing Præcipe certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

BEFORE U. S. BOARD OF TAX APPEALS

PRÆCIPE—Filed October 16, 1930

To the clerk of the United States Board of Tax Appeals:

In addition to the papers indicated in the præcipe for record filed with you on October 9, 1930, by the General

Counsel for the Commissioner of Internal Revenue, petitioner-on-review, you will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the First Circuit (1) a duly certified copy of the lease dated March 1, 1893, from the Old Colony Railroad Company to the New York, New Haven and Hartford Railroad Company, which lease appears in the findings of fact in the case of Appeal of Old Colony Railroad Company, Docket No. 1024, 1 B. T. A. 1066, said lease being printed on pages 1068, 1069, 1070 and 1071 of Volume 1 B. T. A.

This lease is a part of the findings of fact of the Board in [fols. 83 & 84] the instant case, being incorporated therein by reference. (See last paragraph on page 268, 18 B. T. A.)

It is suggested that said lease be marked "8 (a)" and included in the record following the findings of fact and opinion of the Board.

Please also include in said record (2) a copy of this præcipe.

J. S. Y. Ivins, Attorney for Respondent on Review.

Now, November 18, 1930, the foregoing Præcipe certified from the record as a true copy.

B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

[fol. 85] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT, OCTOBER TERM, 1930

No. 2515

COMMISSIONER OF INTERNAL REVENUE

v.

OLD COLONY RAILROAD COMPANY, Petitioner for Review

Appeal from Board of Tax Appeals

Before Bingham, Wilson, and Lowell, JJ.

OPINION OF THE COURT—Filed June 10, 1931

LOWELL, J:

This is an appeal by the Commissioner of Internal Revenue from a decision of the Board of Tax Appeals. The suit

Upon consideration whereof, It is now, to wit, June 10, 1931, here ordered, adjudged and decreed as follows:
[fol. 88] The order or decision of the Board of Tax Appeals is reversed and the case is remanded to that Board for further proceedings not inconsistent with the opinion passed down this day.

By the Court.

Arthur I. Charron, Clerk.

Thereafter, to wit, on August 11, 1931, mandate issued to the United States Board of Tax Appeals.

Clerk's certificate to foregoing transcript omitted in printing.

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 26, 1931

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the First Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(1303)

FILE COPY

FILED
SEP 3

In the Supreme Court of the United States.

OCTOBER TERM, 1930

No. oo 349

OLD COLONY RAILROAD COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT AND BRIEF IN SUPPORT THEREOF

J. S. Y. IVINS,
Attorney for
Old Colony Railroad Company,
c/o Brewster, Ivins & Phillips,
Southern Building,
Washington, D. C.

INDEX

	Page
Petition	1
Question Presented	1
Statement	2
Specification of Errors	4
Reasons for Granting the Writ	4
Brief	7
Opinion below	7
Jurisdiction	7
Statement	7
Summary of Argument	10
Argument	11
I. The Government's new theory is unsound	11
II. The statutory provision for the deduction from gross income of all interest paid on indebtedness, precludes the application of the Government's new theory	16
III. Even if the Government's new theory were sound, it would not be applicable to the present case, where the interest on the taxpayer's bonds was paid by its lessee	18
Conclusion	19

CASES CITED

Brewster *v.* Gage 280 U. S., 327	15
Chicago, Rock Island & Pacific Ry. Co. *v.* Commissioner, 47 Fed. (2d) 990	5, 9
Commissioner *v.* Old Colony R.R., 26 Fed. (2d) 408	7, 11
Doyle *v.* Mitchell Bros. Co., 247 U. S. 179	8
Fall River Electric Light Co. *v.* Commissioner, 23 B.T.A. 168	9
Goodrich *v.* Edwards, 255 U. S. 527	8
Hays *v.* Gauley Mountain Coal Co., 247 U. S. 189	8
Lynch *v.* Alworth Stephens Co., 267 U. S. 364	8, 12
Lynch *v.* Turrish, 247 U. S. 221	00
Merchants' Loan & Trust Co. *v.* Smietanka, 255 U. S. 509	8
National Lead Co. *v.* U. S., 140	15
National Life Insurance Co. *v.* U. S. 277 U. S. 508	5
Old Colony Railroad Co. *v.* Commissioner 6 B. T. A. 1025	3
Southern Pacific Co. *v.* Lowe, 247 U. S. 330	8
United States *v.* Woodward, 256 U. S. 632	17

In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 00

OLD COLONY RAILROAD COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT AND BRIEF IN SUPPORT THEREOF

PETITION

The undersigned on behalf of the Old Colony Railroad Company prays that a writ of certiorari issue to review the final decree of the United States Circuit Court of Appeals for the First Circuit entered in the above-entitled case on June 10, 1931 reversing the decision of the United States Board of Tax Appeals.

QUESTION PRESENTED

Should premiums received by a taxpayer on the sale of long-term corporation bonds issued prior to 1904 (when the taxpayer's accounts were on a cash basis) and outstanding during 1921, be regarded as in any part income accruing in that year, either for the purpose of being treated as taxable income or for the purpose of offsetting

concerns income taxes for the year 1921 which the Commissioner contends are due from the Old Colony Railroad Company.

In 1893 the Old Colony leased its railroad lines to the New York, New Haven and Hartford Railroad Company, under an arrangement whereby the New Haven was to operate the railroad and pay a certain rental, including all taxes. Between 1893 and 1904 the Old Colony issued long-term bonds, which were sold at premiums amounting to $199,528.08. It kept its books on a cash payment basis until compelled by the Interstate Commerce Commission to keep them on an accrual basis.

The question to be solved in the case at bar is whether profit arising from the sale of the bonds may be taken into account in determining the expense to be allowed the Old [fol. 86] Colony as a deduction. If the books were kept on a cash basis the deduction allowable would be the interest paid on the bonds, and only that, as that would be the cash disbursement for the year. The Commissioner contends, however, that the real expense in connection with the payment of the interest on the bonds is the amount of it less an aliquot part of the profit, apportioned to the year 1921, amounting to $6,960.64, as the bonds cost the company less than the amount represented by the rate of interest.

There are no authorities precisely in point, and the decided cases in which somewhat similar questions arose relate to companies whose books were kept on a cash basis. See, for instance, Baldwin Locomotive Works v. McCoach, 221 F. 59; Chicago & Alton R. R. Co. v. United States, 53 Ct. Claims, 41. But there is one decided case which is the converse of the case at bar. In Western Maryland Ry. Co. v. Commissioner, 33 F. (2d) 695, a corporation whose bonds were sold at a discount was allowed to figure the proportionate part of the discount as an expense for the year. The same principle applies to the case at bar. If a corporation is allowed to show a greater expense for a given year by adding a proportionate part of a loss on the sale of bonds, there seems no reason to deny to the taxing authorities the right to show a smaller expense by deducting the proportionate part of a gain on a sale of bonds.

Such a result may seem contrary to the case in this circuit of Commissioner v. Old Colony Railroad Company, 26 F. (2d) 408, which involved a similar state of facts. The deci-

sion was that a profit made in 1904, before the passage of the Sixteenth Amendment to the Constitution of the United States, could not be taxed. The court's attention was not called to the fact that the profit made in the early years was not being taxed, but that it was being used only to determine the expense for the year 1921 of the payment of interest on the bonds. This is not a tax but an allocation, under proper accounting methods for books kept on the accrual basis, of the expense chargeable to the year 1921. See Chicago, Rock Island & Pacific Ry. Co., 13 B. T. A. 989, 1029.

It may be true that the regulations of the Treasury De- [fol. 87] partment (see Article 332 of Regulations 74) are so framed as not to provide for amortization of premiums, but the Treasury regulations are founded on the law, and if the law allows this to be done the regulations cannot prevent it,—a river can rise no higher than its source.

The case of Commissioner v. Old Colony Railroad, ubi supra, is not inconsistent with the amortization of premiums for the purpose of ascertaining the expense properly chargeable to the year 1921. Compare, in this connection, Indiana Harbor Belt R. R. Co. v. Commissioner, 16 B. T. A. 279, with Terminal R. R. v. Commissioner, 17 B. T. A. 1135, 1167.

The order or decision of the Board of Tax Appeals is reversed and the case is remanded to that Board for further proceedings not inconsistent with this opinion.

On April 23, 1931, this case came on to be heard, and was fully heard by the court, Honorable George H. Bingham and Honorable Scott Wilson, Circuit Judges, and Honorable James A. Lowell, District Judge, sitting.

IN UNITED STATES CIRCUIT COURT OF APPEALS

FINAL DECREE—June 10, 1931

This cause came on to be heard April 23, 1931, upon the record upon petition for review of the United States Board of Tax Appeals and was argued by counsel:

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In failing to follow its own decision rendered in the case of the same taxpayer for the preceding calendar year (26 Fed. (2d) 408) which held, on the authority of numerous decisions of the Supreme Court, that premiums received by the taxpayer prior to the adoption of the Sixteenth Amendment were not taxable in any part for the year 1920.

2. In failing to hold that the provisions of Section 234 (a) (2) of the Revenue Act of 1921 allowing as a deduction from gross income "all interest paid or accrued within the taxable year on its indebtedness" entitle the taxpayer to a deduction of all such interest without adjustment for premiums received upon the sale of bonds prior to the adoption of the Sixteenth Amendment.

3. In making the assumption, unsupported by the record, "that the profit made in the early years was not being taxed, but that it was being used only to determine the expense for the year 1921 of the payment of interest on the bonds."

4. In holding that "the case of Commissioner *v.* Old Colony Railroad Company, supra, is not inconsistent with the amortization of premiums for the purpose of ascertaining the expense properly chargeable to the year 1921."

REASONS FOR GRANTING THE WRIT

The decision of the Circuit Court of Appeals (Bingham, Wilson and Lowell, JJ) is in direct conflict with the decision of the same Court (Bingham, Johnson and Hale, JJ) in the case of the same taxpayer for the preceding calendar year (26 Fed. (2d) 408) which held that since the premiums were received by the taxpayer prior to the adoption of the Sixteenth Amendment they were not intended by the Revenue Act of 1918 to be taxed in any part as income for 1920 and that Congress could not have

taxed them as income for 1920 had it desired to do so. The reconciliation suggested in the last opinion of the Circuit Court of Appeals between it and the first opinion is an attempt to approve the accomplishment by indirection of a result which was condemned when accomplished directly, and is accordingly out of harmony with *National Life Ins. Co.* v. *U. S.*, 277 U. S., 508 and other decisions of this court.

The last opinion of the Circuit Court of Appeals for the First Circuit is out of harmony with the opinion of the Circuit Court of Appeals for the Seventh Circuit in *Chicago, Rock Island & Pacific Railway Co.* v. *Commissioner*, 47 Fed. (2nd) 990, which relied upon the first opinion of the Circuit Court of Appeals for the First Circuit as authority for holding in favor of the Government that the cost of selling bonds prior to 1913 could not be amortized and charged as deductions in years subsequent thereto.

In petitioning to this Court for certiorari to review the first decision of the Circuit Court of Appeals, the Solicitor General stated "The question involved is one of great public importance, and vitally affects the Government in its administration of the revenue laws. It is a question which should be finally settled by this Court * * *". The question, not yet having been settled by this Court, is presumably in the same status, for it can hardly be said that a question is important when the decision of the lower court was unfavorable to the Government but unimportant when it was favorable.

The statistics (as of January 1, 1918) given by the Solicitor General in his petition in the earlier case and in his brief in support of that petition for the purpose of showing the importance of the question then raised as to the year 1920, are equally applicable in determining the importance of the same question when raised as to the year 1921.

WHEREFORE, it is respectfully submitted that this petition for writ of certiorari to review the judgment of the Circuit Court of Appeals for the First Circuit should be granted.

J. S. Y. IVINS,
Attorney for
Old Colony Railroad Company,
c/o Brewster, Ivins & Phillips,
Southern Building,
Washington, D. C.

September 4, 1931.

BRIEF

OPINION BELOW

The opinion of the Circuit Court of Appeals for the First Circuit appears in the record at page 73. It is not yet officially reported.

JURISDICTION

The final decree of the Circuit Court of Appeals was entered on June 10, 1931 (R. p. 75). The jurisdiction of this Court is invoked under section 347 of the United States Code (Act of February 13, 1925 Ch. 229 § 1).

STATEMENT

The facts are set forth in the statement in the annexed petition (p. 2, supra).

The original theory of the Government with respect to the proper treatment of premiums on bonds* for the purposes of the income tax laws, was that such premiums were in themselves income, deemed to be realized (by a taxpayer reporting income on the accrual basis) ratably over the life of the bonds. This theory was first set forth in 1919 in Treasury Regulations 45, Article 544 (2) (a) which provided:

> "If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds."

Similar language has appeared in all income tax regulations since promulgated.

In the first Old Colony Railroad Company case (26 Fed. (2d) 408) the Circuit Court of Appeals did not deny this principle but held in effect that it was not applicable to a case where the bonds had been issued and the pre-

* i.e. the excess of the price realized by the obligor upon their original sale over their face or par value.

miums realized prior to the adoption to the Sixteenth Amendment to the Constitution, when the taxpayer kept its accounts on the basis of cash receipts and disbursements. Its decision was based on numerous opinions of this Court to the effect that property which was part of the taxpayer's capital before the Sixteenth Amendment could not be taxed as income thereafter.*

The Solicitor General filed a petition for certiorari, which was allowed (October Term 1928, No. 407) and he then filed a brief in this Court on an entirely new theory, arguing that the premiums were *not* income, but additional borrowed money, to be repaid in the form of part of the interest contracted for. Accordingly he claimed that ratable portions of the premiums should not be *added* to *income* (as the Regulations provided) but that the taxpayer's deduction from gross income for interest paid on indebtedness should be reduced each year by a ratable proportion of the premium.

On discovering that the record before this Court was insufficient to sustain his argument, the Solicitor General moved for dismissal of his writ of certiorari,† and the Government prepared to take up another case with a fuller record.

The second case of the same taxpayer (which is the present case at bar) had been tried before the Board of Tax Appeals on a record which (as far as this point is concerned) was similar to that in the first case. It was decided by the Board on November 19, 1929 in favor of

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* Lynch *v.* Turrish, 247 U. S. 221, 38 S. Ct. 537, 62 L. Ed. 1087; Southern Pacific Co. *v.* Lowe, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142; Doyle *v.* Mitchell Bros. Co., 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054; Hays *v.* Gauley Mountain Coal Co., 247 U. S. 189, 38 S. Ct. 470, 62 L. Ed. 1061; Merchants' Loan & Trust Co. *v.* Smietanka, 255 U. S. 509, 41 S. Ct. 386, 65 L. Ed. 751, 15 A.L.R. 1305; Goodrich *v.* Edwards, 255 U. S. 527, 41 S. Ct. 390, 65 L. Ed. 758.

† The motion was granted April 15, 1929; 279 U. S. 876.

the taxpayer on the authority of the decision of the Circuit Court of Appeals in the first case (R. pp. 40 50). Upon joint motion of the parties* the Board's decision was vacated and further facts found in accordance with a stipulation,† to make the record show that the taxpayer had taken a deduction, from its 1921 gross income, of interest paid on indebtedness. Counsel for the Government then presented the new theory to the Board and requested reconsideration of the issues, which the Board denied on June 19, 1930.‡ The Board's original determination was reinstated as of that date.

Subsequently the Board had occasion to review the whole subject in a case where the Government presented the new and old theories in the alternative. It held that the old theory was sound, and should be applied in a case where the bonds had been issued after the adoption of the Sixteenth Amendment, distinguished the first decision of the Circuit Court of Appeals in the Old Colony Railroad 1920 case on the ground that there the bonds had been issued before the Sixteenth Amendment, *and rejected the new theory as unsound.*§

The Government took the second Old Colony Railroad case to the Circuit Court of Appeals for the First Circuit, and urged the new theory. That court (only one of the judges who had sat in the first case being present) accepted the new theory and reversed the Board.|| It distinguished its earlier decision (which had been accepted as sound in the Seventh Circuit)¶ on grounds which, we submit, are erroneous.

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* R. p. 64.

† R. p. 64.

‡ R. p. 66.

§ *Fall River Electric Light Co.* v. *Commissioner*, 23 B.T.A. 168.

|| R. p.

¶ *Chicago, Rock Island & Pacific Railway Co.* v. *Commissioner*, 47 Fed. (2d) 990.

SPECIFICATION OF ERRORS

See petition at p. 4, supra.

SUMMARY OF ARGUMENT

I. The taxpayer's bonds were sold at a premium between 1893 and 1904, when the taxpayer's accounts were kept on a cash basis. In a litigation over its 1920 income tax the same Circuit Court of Appeals (but with two different judges out of three) held that the premiums, having been part of capital before the adoption of the Sixteenth Amendment could not be taxed as income thereafter. Then the Government evolved a new theory —that instead of being *income*, the premiums were borrowed capital, to be returned as part of the interest contracted for, and that the taxpayer's deduction for interest in each year should be reduced by a ratable proportion of the premiums. This theory is in conflict with Treasury Regulations and statutory reenactments. It is also unsound, being based on circular reasoning—the conclusion being the only basis of the premise from which the conclusion is reached. The Regulations are sound, but are not applicable to a case where the premiums became capital before the Sixteenth Amendment. The opinion below shows confusion in the mind of its writer as to what the Regulations provide.

II. The statute allows the deduction from gross income of "all interest paid on indebtedness" and precludes the reduction of that deduction, even if some of the interest does constitute a capital transaction, in the same manner that estate taxes are deductible although they affect capital and not true income.

III. Because of the provisions of the lease, the taxpayer gets no benefit from the premiums until 1992, and at most could only be taxable for 1921 on the present value $6,960.64 payable in 1992, or about $445.

ARGUMENT

Point I

The Government's New Theory is Unsound

The Old Colony bonds were sold at a premium between 1893 and 1904, when the company kept its books on a cash basis.* The premiums were received at that time. In the first case the Circuit Court of Appeals held:†

> "It is not to be presumed that Congress by the act of 1918 intended to tax the whole or any part of the premiums on bonds received prior to February 25, 1913, whether the life of the bonds extended into a taxable year subsequent to February 25, 1913, or not, as it was beyond its power to do so at the time they were received."

citing the cases from this Court listed in the footnote to p. 8 supra.

Then the Government evolved its new theory.

Article 544 of Regulations 45‡ interpreted the Revenue Act of 1918. The same interpretation has been placed upon every subsequent revenue act by every subsequent edition of Treasury Department regulations.§ It is interesting to note that even after the Department of Justice had evolved its new theory and applied to this Court for certiorari in the 1920 case, the Treasury Department, under date of January 3, 1929, promulgated Regulations 74 reiterating the article which the Government's theory rejects as unsound, and that although the Treasury Department has promulgated dozens of amendments to the regulations in the last two years it has not amended this article.

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* See second paragraph of opinion below, R. p. 74.

† *Commissioner* v. *Old Colony Railroad Company*, 26 Fed. (2d) 408, 410.

‡ Quoted above, p. 7.

§ Regulations 62, Art. 545; Regulations 65, Art. 545; Regulations 69, Art. 545; Regulations 74, Art. 68.

As Mr. Justice Sutherland quoted in *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364, 370:

> "And the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover."

If the Government's new theory were obvious and rational, we might almost be justified in wondering how the Treasury Department could have kept writing and rewriting regulations for the last 12 years without discovering it. The Regulations, we submit, express the obvious and rational meaning of the statute, and they have been found satisfactory and have been approved by the Board of Tax Appeals and the Courts—as far as they go. The Circuit Court of Appeals did not hold in the first Old Colony case that Article 544 of Regulations 45 was wrong. The effect of the decision was merely to hold that the regulation had no application to premiums received before 1913. It was clear to the Court that, upon the theory which was the basis of the regulation and which had been the basis of the Government's action in all the cases involving premiums received after 1913, it was necessary to cut off the application of the regulation at the effective date of the Sixteenth Amendment, for under the theory on which the regulation was based there was a constitutional objection to taxing as income in 1920 something which had become capital* before the Sixteenth Amendment permitted the taxation, without apportionment, of income from property. But now the Government in its effort to justify a tax in 1921 on property received in 1895–1904 is ready to abandon the regulations under five successive Revenue Acts and set up in

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* Whether it ever passed through the phase of being income or not.

their place a theory which, we submit, comes within the second category of Mr. Justice Sutherland's classification, above. The Government's new theory is that

> "When the bonds in question were issued there was a rate of interest at which they could have been sold on the market at par. This rate is known as the effective rate. Because the taxpayer was willing to pay a higher rate of interest, it was able to sell them at a premium. These premiums are lump payments made in return for the obligation which the taxpayer assumed to pay such higher rate of interest during the life of the bonds. The premiums represent the present value, as of the date of sale of the bonds, of the annual payments represented by the excess interest which the taxpayer thus agreed to make during the life of the bonds. The premiums are thus repaid dollar for dollar in installments and in the form of excess interest on the face of the bonds."

This is all fine theorizing but it is not based on a single known demonstrable fact either in the record or elsewhere. John Dewey, in "Experience and Nature," says:

> "Systems have always worked with loaded dice; their premises have been framed to yield desired conclusions."

The Government takes for its major premise the proposition that "when the bonds in question were issued there was a rate of interest at which they could have been sold on the market at par." We are certainly entitled to be told what the Government claims that rate, which it calls "the effective rate," to have been. Only thus will we be in a position to verify by mathematics whether the conclusion does follow from the premise. But we should not be asked to determine the rate which is to constitute the premise, by reasoning backward from the conclusion.

The factors going to determine the price at which a bond will sell are legion. The rate of interest offered is,

a part of the interest deducuon allowed under Section 234 (a) (2) of the Revenue Act of 1921?

The Board of Tax Appeals has answered this question in the negative in two cases litigated between the Old Colony Railroad Company and the Commissioner of Internal Revenue.* The Circuit Court of Appeals for the First Circuit (Circuit Judges Bingham and Johnson and District Judge Hale) affirmed the first decision of the Board of Tax Appeals (26 Fed. (2d) 408). The same court (Circuit Judges Bingham and Wilson and District Judge Lowell) reversed the Board in the second case (R. p. 73).

This court on the petition of the Solicitor General allowed a writ of certiorari in the first case (October Term, 1928, No. 407) but the writ was dismissed on the Solicitor General's motion.

The taxpayer now seeks to review the second decision of the Circuit Court of Appeals, urging grounds similar to those presented by the Government in support of the petition to review the first decision.

STATEMENT

Between 1895 and 1904, while all the taxpayer's property was under lease to The New York, New Haven and Hartford Railroad Company, bonds were issued in the name of the taxpayer which were sold at a premium in excess of their face amount, aggregating $199,528.08. At this time the taxpayer's books were kept on a cash payment basis. In [illegible], the Interstate Commerce Commission required the taxpayer, for the purpose of its reports to that Commission, to amortize the premiums over the periods of the respective lives of the bonds. Under protest, the taxpayer for each year subsequent to 1914 reported to the Interstate Commerce Commission a portion of such premiums as income. But on its books it credited such proportion to Profit and Loss account (a

*6 B.T.A. 1025, and 18 B.T.A. 267, 275.

surplus account) and not to its Income account. The amount so credited to Profit and Loss account for 1921 was $6,960.64.

The taxpayer, having received no part of this $6,960.64 in 1921 and being unable (because of the lease) to receive any benefit from the fact that the bonds had been sold at a premium until the termination of the lease in 1992, did not include the $6,960.64 as part of its taxable income in its income tax return for 1921 filed with the Treasury Department.

In auditing that income tax return, the Commissioner of Internal Revenue increased the taxpayer's taxable income for the year 1921 by such amount of $6,960.64 and proposed to assess a deficiency tax accordingly. The Board of Tax Appeals, on the authority of its decision in the case of the same taxpayer for the preceding tax year (*Old Colony Railroad Company* v. *Commissioner*, 6 B.T.A. 1025) and the affirmance of that decision by the Circuit Court of Appeals for the First Circuit (26 Fed. (2d) 408), held that no part of the premiums in question represented income to the petitioner in 1921. Subsequently, the Commissioner moved the Board for reargument and reconsideration, and presented to the Board further arguments directed to the question whether the portion of the bond premiums treated by the Commissioner as income should not be given consideration in determining the interest deduction of the taxpayer for the purpose of determining its net taxable income. After consideration of this argument, the Board of Tax Appeals reinstated its order of redetermination holding that the taxpayer's net taxable income for 1921 should not be increased by reason of the premiums received between 1895 and 1904 on the sale of its bonds.

This decision of the Board of Tax Appeals was reversed by the Circuit Court of Appeals for the First Circuit in an opinion rendered June 10, 1913, per Lowell, D.J.

of Appeals in the first Old Colony Railroad case (which is not overruled in the decision we seek to review and which was accepted as sound in the Seventh Circuit) **there was no intent to tax as income something which was capital of the taxpayer before the Sixteenth Amendment.**

Judge Lowell, writing the opinion below, was apparently much confused as to what the Regulations do provide. In the last paragraph but two of the opinion (R. p. 75) he assumes that they do not provide for amortization of premiums, and that they attempt to prevent it. But they do provide for such amortization **by the process of treating the premiums as income**—and accordingly are applicable in all cases where the premiums had not become capital before the adoption of the Sixteenth Amendment.

Point II

The Statutory Provision for the Deduction from Gross Income of All Interest Paid on Indebtedness, Precludes the Application of the Government's New Theory

Section 234 of the Revenue Act of 1921 provides:

> "(a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions—
>
> " * * * (2) **All interest** paid or accrued within the taxable year on its indebtedness." (Emphasis supplied)

The statute says nothing about "effective rates" of interest paid, but **"all interest."** It must be interpreted in the light of the commonly accepted meaning of the term "interest."

The bonds in the present case, outstanding in 1921, called for the payment of $538,920 interest. The New Haven, under the lease, undertook to pay "the interest

on the lessor's bonded indebtedness" (R. 20). If the New Haven had failed to pay $6,960.64 of the $538,920 called for in the bonds, could it claim that it had not defaulted under its covenant to pay interest? Could it pay the full $538,920 but charge $6,960.64 to the Old Colony as a payment of principal, and call upon the Old Colony to issue new bonds to refund it as principal indebtedness? We do not believe that any court would so hold.

The Government made a very similar argument in *United States* v. *Woodward*, 256 U. S. 632. Section 214 (a) of the Revenue Act of 1918 provided for the deduction from gross income of "taxes paid or accrued" with specified exceptions. The Government contended that the estate tax was not a "tax" within the meaning of Section 214 (a), because it was in reality a segregation of part of the estate which was prevented from passing to the executor—a partial escheat. It also contended that the estate tax was a capital transaction, not affecting true income, but merely reducing a capital receipt of a type specifically excluded from taxable income. This Court readily disposed of both contentions on the ground that the estate tax was designated as a "tax" in the act imposing it, and that it was imposed in the exertion of the taxing power of the United States. It therefore came within the provision allowing the deduction of taxes.

The Court did not bother to answer the argument with respect to the capital nature of the estate tax, except by saying that it did not constitute a segregation but was a charge against the estate.

But the capital nature of the transaction would not prevent a deduction in the computation of net income, if Congress elected specifically to allow it as a deduction. If a capital asset is destroyed by casualty, the loss does not actually affect income, any more than does a gift. However, Congress permits the deduction of capital

losses due to casualty* but does not permit the deduction of gifts out of capital, though the effect on the taxpayer's capital, and lack of effect on his income is the same in each case.

Congress has allowed the deduction of "all interest" which precludes any argument as to whether part of the interest paid is properly a capital transaction. If the payment was "interest," it is a proper deduction—"all" of it, and not merely the "effective rate."

The transactions in this case were of the commonest kind. The Old Colony, in issuing bonds at an interest rate which would cause them to sell at a premium can hardly be accused of fraudulent intent to evade an income tax, enacted many years later. In the absence of fraud, we should interpret the language of the bonds in the sense in which it was undoubtedly understood by the parties, would commonly be understood among men—that is, that the payments, required to be made as "interest," were "interest" in the commonly accepted meaning of the word.

Point III

Even If the Government's New Theory Were Sound, It Would not be Applicable to the Present Case, Where the Interest on the Taxpayer's Bonds Was Paid By Its Lessee

The properties of the Old Colony, including the proceeds, both face amount and premium, of the bonds sold, were under lease to the New Haven for a term which, unless sooner ended by some highly improbable event, would run until 1992. The proceeds of the bonds were presumably used as provided in the lease (R. 18), for the purpose of making permanent improvements upon the property demised or for the purpose of discharging the Old Colony's indebtedness. If it was spent for im-

* cf. Revenue Act of 1921, § 214 (a) (6).

provements, the New Haven would have the benefit of the improvements until 1992. If it went to reduce indebtedness, the New Haven would be similarly benefited until 1992, for by the lease it undertook to carry the Old Colony's funded indebtedness along, refunding and paying interest as necessary, and to assume and pay all the other obligations of the Old Colony. The receipt of the premiums during the term of the lease was like an increment in the value of the real property demised. It could not benefit the lessor until the termination of the lease.

On an accrual basis, the Government might be justified in treating as income to the Old Colony in 1921 the present value in that year of the right to $6,960.64 receivable in 1992, which on a 4% compound discount basis would be about $445. But in order to justify even this adjustment to the Old Colony's income, the Government must sustain the soundness of its theory. If the Government's theory be sound, it is applicable to the Old Colony at best only to the extent of an increase in 1921 income of about $445. If it be unsound, of course it cannot justify even that adjustment.

It should be noted that although this argument was presented to the court below, the opinion makes no attempt to meet it.

Conclusion

The writ should be allowed as prayed for in the petition.

Respectfully submitted,

JAMES S. Y. IVINS,
Attorney for
Old Colony Railroad Company.

September 4, 1931.

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CHARLES ELMORE

REPLY BRIEF FOR PETITIONER

In the Supreme Court of the United States.

OCTOBER TERM, 1931

No. 349

OLD COLONY RAILROAD COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

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INDEX

Page

Statement 1

Summary of Argument 2

I. Section 234 (a) (2) of the Revenue Act of 1921 permitted the petitioner to deduct from its gross income "all interest paid or accrued within the taxable year on its indebtedness" without limitation. There is no authority in law for reducing this deduction by a proportion of premiums received on the sale of the bonds 3

II. If the petitioner's deduction for interest should be reduced as the Government insists, its income should be similarly reduced in the same amount 7

III. The rule as to amortization of discounts has no application to premiums, where the bonds were issued before March 1, 1913 8

IV. The method in which petitioner's books were kept in 1921 does not justify the proposed tax 10

Conclusion 14

CASES CITED

Chicago, Rock Island & Pacific Ry. Co. *v.* Commissioner, 13 B. T. A. 988 ..... 9, 10, 13

Commissioner *v.* Old Colony Railroad Co., 26 Fed. (2d) 408 1

Connecticut & Passumpsic Rivers R.R. Co. *v.* Commissioner, 24 B. T. A. 394 7

Fall River Electric Light Co. *v.* Commissioner, 23 B. T. A. 168 ..... 7, 13

Henrietta Mills Inc. *v.* Commissioner, 52 Fed. (2d) 931, C. C. A. 4th, June 30, 1931, affirming 20 B. T. A. 651 5

Kansas City Southern Ry. Co. *v.* Commissioner, 16 B. T. A. 665, — Fed. (2d) — 12

Lynch *v.* Turrish, 247 U. S. 221 3

National Life Ins. Co. *v.* United States, 277 U. S. 508 4

New York Life Ins. Co. *v.* Edwards, 271 U. S. 109 5

of course, one factor. The prosperity of the obligor's business; its future prospects, the value of the mortgaged property securing the bond, the condition of the money market, determined largely by general business conditions, the competition among lenders, even current crop forecasts and prospects of political parties in approaching elections affect the price at which a bond will sell, and that price is likely to vary not only from day to day but from minute to minute. In attempting to sustain their theories, the accountants quoted in the Government's brief below reason in circles. One of them says:*

> "If the credit of the company and the conditions of the market would have enabled the company to issue a five per cent twenty-year bond at par, its six per cent bond, running at the same time, should sell at approximately 112.46."

Of course it should in order to sustain the theory. If the theory will sustain the premise, the premise in turn will sustain the theory. But can the Government prove by any evidence on which a court could make a finding of fact that his six per cent bond would have sold at 112.46? Any one who has had any experience in the securities market knows that at one time long term bonds will sell "to yield" a higher rate than short term bonds of equal security, and at other times the short term bonds will be preferred. If the bidders are under the general impression that interest rates are likely to decline, they will prefer long term bonds in the hope not only that they will receive in later years higher rates of interest than would then be obtainable on new investments, but that they will also be able to realize an increased principal price on the resale of the bonds. On the other hand, if purchasers foresee higher interest rates, they will prefer short time securities which will mature and be paid, thus putting

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* Government's brief below, p. 17.

them in funds to reinvest at the expected better interest rates.

The same kind of difference exists between bonds carrying interest at rates high enough to sell at a premium and bonds carrying interest low enough to sell at a discount. A man who invests $110 in a premium bond expects a higher rate of interest because he will get back only $100 at maturity. The difference in interest rate will compensate him for the lesser amount to be received at maturity. Conversely with the purchaser of bonds at a discount. We do not question that to some extent this compensation goes to adjust the difference between par and the selling price of the bond. But to assume that there is any exactness about it and that the purchaser would have taken the same bonds at par "to yield" the same return is just as unsafe as to assume that a purchaser would be equally willing to buy long term bonds or short term notes "to yield" the same return. The same factors that influence the purchaser of short time notes to desire to get his money back soon, will induce him to buy bonds at a premium. And the same factors that induce another to prefer long term bonds, will induce him to prefer bonds selling at a discount.

We are now concerned with a 1921 income tax case. The Revenue Act of 1921 imposed the income tax in the same phraseology as the Revenue Act of 1918, reenacting the language in the light of the departmental construction contained in Article 544 of Regulations 45. It adopted the principle quoted on p. 7 above, which is wholly inconsistent with the Government's new theory. And every Revenue Act and every Treasury Regulation since has done the same thing. The legislative intent in the 1921 Act can be found in the departmental construction of the 1918 Act.* But, as held by the Circuit Court

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* *National Lead Co.* v. *U. S.*, 252 U. S. 140, 146; *Brewster* v. *Gage*, 280 U. S.; 327, 337.

In the Supreme Court of the United States

OCTOBER TERM, 1931

No. 349

OLD COLONY RAILROAD COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

REPLY BRIEF FOR PETITIONER

Statement

Petitioner respectfully refers the Court to the brief printed with the petition for a writ of certiorari, which is relied upon as petitioner's brief in chief upon the merits.

The facts are set forth in the petition (p. 2 thereof). The facts are stated in more detail in the brief for respondent (pp. 2–7).

The Government originally claimed that the premiums received on the sale of bonds constituted income—gain derived from capital. After the decision of the Circuit Court of Appeals in the first test case,[1] holding that the premiums were income, but not taxable if realized before March 1, 1913, it changed its ground and urged a wholly inconsistent theory—that the premiums were not income but that the deduction for interest paid

[1] *Commissioner* v. *Old Colony Railroad Co.*, 26 Fed. (2d) 408.

should be limited. In its brief before this Court the Government seems to be trying to rely upon both theories at the same time saying at some points that the premiums are gross income[1] and at others that they are not.[2] Despite the confusion in the Government's brief it is clear that the Government's position must be either (1) that the premiums are to be included in gross income for 1921 although realized before March 1, 1913, or (2) that the taxpayer is not entitled to deduct "all interest" under section 234(a) (2) because the deduction allowed by Congress is excessive.

Summary of Argument

The $6,960.64 added by the Government to petitioner's gross income for 1921 was not income to the petitioner in that year, but had become part of its capital before March 1, 1913.

The Treasury Department had no right to reduce the deduction for "all interest paid on indebtedness" provided by the statute.

If any part of the interest paid should be excluded from petitioner's deductions, it should be equally excluded from its income represented by interest paid by its lessee.

Premiums are realized when bonds are sold, discounts when they are redeemed. Congress may tax premiums received after March 1, 1913 and may permit the tax to be spread over the life of the bonds, but it cannot tax premiums received before March 1, 1913. It may, in its discretion, allow deductions for discounts, whenever realized. Accordingly, decisions with respect to discounts do not necessarily apply to premiums where the bonds were sold prior to March 1, 1913.

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[1] e.g. p. 2, line 7; p. 22, line 2.

[2] e.g. p. 15, line 26; p. 16, line 7; p. 20, line 25; p. 21, third line from bottom.

The methods of accounting adopted by the Interstate Commerce Commission for its own purposes, which do not involve the effective date of the Sixteenth Amendment, are not controlling for the purposes of computing taxes under the Revenue Acts.

ARGUMENT

I.

Section 234(a)(2) of the Revenue Act of 1921 permitted the petitioner to deduct from its gross income "all interest paid or accrued within the taxable year on its indebtedness" without limitation. There is no authority in law for reducing this deduction by a proportion of premiums received on the sale of the bonds.

The problem under consideration is a question of statute law and should not be confused by theories evolved to justify bookkeeping methods proposed by accountants. The important factor, which does not concern theorizing accountants, nor Interstate Commerce Commissioners compiling data for regulating railroad rates, is the effective date of the Sixteenth Amendment to the Constitution.

An accountant, theorizing on gain and loss, would say that if A bought an asset in 1894 for $100 and sold it in 1921 for $200, he had a gain of $100. But for income tax purposes we can only treat as taxable that part of the gain found by the accountant to have been realized in 1921 which resulted from increment subsequent to March 1, 1913.[1] Similarly, the Interstate Commerce Commission, for the purpose of making rates might require a railroad company to deduct depreciation on the basis of the cost of assets acquired in 1905, but in computing an income tax we must take the March 1, 1913 value for a base.

[1] *Lynch* v. *Turrish* and other cases cited in first footnote on p. 8 of brief annexed to petition for certiorari.

The Treasury Department by a series of unchanging regulations, ruled that premiums received on the sale of bonds constituted **gain or income.**[1] The regulations required this **income** to be pro-rated or amortized over the life of the bonds, rather than included in gross income in the year of receipt. Whether the first of these regulations was sound need not concern us, for the reenactment of the statutory basis of the regulation, without change, constituted a Congressional approval thereof in the Revenue Act of 1921, applicable to the present case.

But the regulations contained nothing to indicate any intention to cover premiums on bonds sold before March 1, 1913, and the reenactment of the statute did not adopt any such application.

When the Circuit Court of Appeals held in the Old Colony Railroad's 1920 case[2] that the regulations did not apply to premium-income actually received prior to March 1, 1913, the Government, in order to justify taxing such income, brought forth for the first time its present theory, which **repudiates** all the regulations, in spite of their Congressional adoption by repeated reenactments, and insists that premiums received on the sale of bonds are **not income,** but that they can nevertheless be taxed, even when realized before March 1, 1913, by the process of holding that the provision for deduction of all interest paid does not mean what it says.

The administration proposes a theory under which it can effectively tax income received before 1913. This is substantially parallel to the legislative attempt to tax exempt interest received by insurance companies, condemned by this Court in *National Life Ins. Co.* v. *United*

[1] Regulations 45, Art. 545, etc., see footnote "§" p. 11 of brief annexed to petition for certiorari. Article 848 quoted in Government's brief deals only with discounts, not premiums, and applies only to computation of invested capital, where the effective date of the Sixteenth Amendment is in no way involved.

[2] 26 Fed. (2d) 408.

States, 277 U. S. 508. If income from municipal bonds cannot be effectively taxed by a statutory limitation on deductions, calculated to nullify the exemption, certainly income realized prior to 1913 cannot be taxed through an administrative distortion of the statutory provision which allows the deduction of all interest on indebtedness.

The petitioner undertook, in a typical bond,[1] "to pay to the bearer * * * on the first day of December A. D. 1925, the sum of One Thousand Dollars * * * together with interest thereon at the rate of four per cent per annum, payable on the first days of June and December in each year on the presentation and surrender of the annexed coupons * * *", a typical coupon reading: "On the first day of June 1896, the Old Colony Railroad Company will pay to the bearer * * * Twenty Dollars, being six months interest on its bond No. 0000."

We submit that the indebtedness was $1000, the interest was $20 each half year, that the $20 was all income to the bondholder and not partially a return of capital,[2] and that the whole $20 was interest on indebtedness deductible by the railroad, and not partially a repayment of a principal debt. See point II of brief annexed to petition for certiorari.

The converse of the present question was presented in *Henrietta Mills Inc.* v. *Commissioner*.[3] The taxpayer

[1] R. p. 65.

[2] No part of it being deductible as a return of capital or amortization of premium—*New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109; cf. Treasury ruling known as Office Decision 622, 3 C. B. 89, which reads:

> "Interest received or accrued on bonds purchased at a premium, according to the method employed in keeping books, represents income for the year in which received or accrued at the rate carried by the bonds and not at the rate which would be realized after amortizing the premium."

[3] 52 Fed. (2d) 931, C. C. A., 4th, June 30, 1931, affirming 20 B. T. A. 651.

in 1920 purchased 2000 shares of stock and contracted to pay $650 per share for 500 shares on April 1, 1920, $680,875 per share for 500 shares on January 15, 1921, $719,875 per share for 500 shares on January 15, 1922, and $758,875 per share for 500 shares on January 15, 1923. The Circuit Court of Appeals said:

> "It is contended by the petitioner that the purchase price of all the stock was $650.00 per share as of April 1, 1920, that the total purchase price was to be paid in four installments, and that the excess of the later over the first price amounted to what would have been six per cent. interest and was in fact interest. It is further contended on behalf of the petitioner that to give the contract any other interpretation would be illogical and utterly ridiculous from a business standpoint.
>
> "We cannot agree with petitioner's contention. The courts will not disregard the plain language of a contract or interpolate something not contained in it. Here the language used by the parties is clear and unambiguous, and cannot be ignored however plausible the reasons advanced The courts will not write contracts for the parties to them nor construe them other than in accordance with the plain and literal meaning of the language used. [citations]
>
> "The fact that the later installments exceeded the first by amounts that equaled six per cent. does not of itself prove that the excess was interest. * * *
>
> "Tax liabilities must be determined by what in fact was done. *Remington Rand Inc.* v. *Commissioner of Internal Revenue*, 33 Fed. (2) 77. *United States of America* v. *C. W. Phellis*, 257 U. S. 156."

Congress had power to allow the deduction from gross income of any items it saw fit. It did allow the deduction of all interest, not merely of what the accountants call "effective" interest. The statute contains

nothing diminishing the deduction by what the accountants call "excess interest."[1]

Bond premiums are income as the Regulations have always stated. They are recognized as such by Congressional reenactment in the light of the Regulations. Such of them as were realized prior to 1913 are not within the scope of the income tax law, and they cannot be reached by administrative amendment to the statutory provision allowing deduction of interest.

The Board of Tax Appeals, after careful study, rejected the Government's new theory in *Fall River Electric Light Co.* v. *Commissioner*, 23 B.T.A. 168, and rendered a detailed and well reasoned opinion approving the Regulations which the Government here seeks to repudiate. In *Connecticut & Passumpsic Rivers R.R. Co.* v. *Commissioner*, 24 B.T.A. 394, the Board considered itself controlled rather than convinced by the decision here under review, stating that it regarded the Regulations as correct, but applying them to premiums received before 1913. We submit that the reasoning of the Board in the first of these two cases was correct, and that, in the second, it erred in taxing, as income, premiums realized before 1913.

II.

If the petitioner's deduction for interest should be reduced as the Government insists, its income should be similarly reduced in the same amount.

As the Government says [brief p. 37] the payment of the interest due on the petitioner's bonds by its lessee in reality constitutes additional rent on which the petitioner, as lessor, is liable to pay income taxes. Accordingly it reported in 1921 $538,920 as income—that being the full amount of interest paid by the New Haven in

---

[1] Note that they still call it "interest," even though "excessive" for the purposes of their transcendental theory.

that year on the Old Colony bonds. It claimed a deduction of the same sum, as interest paid.

Now the Government says it was not all interest, but in part repayment of a loan. If $6,960.64 of the second item was not interest but a principal repayment, then $6,960.64 of the first item was not interest either. The New Haven was obliged to pay the petitioner's interest out of its own pocket, but it never undertook to pay the petitioner's principal debts without charging them back or refunding them with new obligations to be executed by the petitioner.

So if $6,960.64 was not interest, the New Haven, in paying it should charge it to the petitioner, just as it charges it with the face amount of bonds which it may retire without refunding. If the item is charged to the petitioner it certainly is not income. If A pays B's butcher's bill for him, the payment may be income to B, but not if B becomes simultaneously indebted to A for the same amount.

If the $6,960.64 was not properly interest, then the petitioner erroneously included that much in the $538,920 which it reported as income. If this error be corrected, it will offset the adjustment the Government wants made to petitioner's item of deductible interest, and there will be no aditional tax to assess.

III.

The rule as to amortization of discounts has no application to premiums, where the bonds were issued before March 1, 1913.

If A sells a $1,000 bond for $1,100 he has a gain of $100, realized at the time of sale. He has actually received $100 more than he has undertaken to repay at maturity. If B sells a $1,000 bond for $900 he will sustain a loss when, at maturity he must pay $1,000. If A

and B kept their accounts on a cash basis, A should properly report his gain in the year of sale of the bond, and B should properly deduct his loss when he realizes it—that is, when he has to pay the $1,000. If they report on the accrual basis, it is reasonable, as the Regulations permit, to treat both alike and amortize both premium and discount.

But if the bonds were sold before March 1, 1913 and mature after that date the situations of A and B are entirely different. A realized his gain at a time when there was no income tax—no constitutional authority for an (unapportioned direct) income tax; but B will realize his loss at a time when the Sixteenth Amendment and the statutes thereunder are in full effect. The income tax law cannot (nor does its language indicate any intent to) reach back and tax A on a gain realized before 1913, but Congress is at perfect liberty to permit B to deduct his loss, when he realizes it. Congress could permit the deduction of the entire loss in the year of maturity of the bond, or, if it saw fit, could deny B any deduction for his loss. Or Congress could allow him to deduct a fraction of his loss. The Government, admitting that what is income is controlled by the Contsitution, has always insisted that deductions are a statutory concept, wholly within the legislative discretion of Congress. The Board of Tax Appeals recognized this position of the Government in the *Rock Island* case quoted on pages 26 and 27 of the Government's brief.

The construction placed upon the statute by the Regulations allows only a partial deduction for the loss suffered by B in the hypothetical case. If his bond ran for 20 years, 10 of them before and 10 after March 1, 1913, he would be allowed to deduct one-half of the loss—five per cent of it in each year after March 1, 1913. We need not quarrel with this rule—everybody seems satisfied with it.

But because Congress is held by the Treasury Department to have intended, in its discretion, to allow B to deduct half his loss (all of which is actually realized in 1923) in ten installments from 1913 to 1923, it does not follow that Congress was at liberty to or intended to tax A on half his gain, **all of which was realized in 1903.**

Accordingly we submit that the Board of Tax Appeals was correct in its reasoning in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, 1027 ff., wherein it allowed the taxpayer to deduct a fraction of the loss by bond discount, in each year after 1913, although the bonds had been sold before 1913 and at the same time recognized the soundness of the ruling of the Circuit Court of Appeals in the first *Old Colony Railroad* case to the effect that premiums realized before 1913 could not be taxed thereafter.

IV.

The method in which petitioner's books were kept in 1921 does not justify the proposed tax.

When the petitioner's bonds were sold in 1894–1905 it was not an operating company. All its property except the corporate seal, stock books, etc., was under lease to the New Haven Railroad.[1] Under the terms of the lease the bonds were issued on the demand of the New Haven, which decided the interest rate to be paid (for the New Haven was obliged to pay that interest). When the bonds were sold, a premium was realized. We contend that this realization benefited only the New Haven—for the Old Colony received no increased rental—and could not benefit the Old Colony until the termination of the lease.

But, for the purposes of this point, we may ignore the fact that the Old Colony was precluded from enjoying

[1] R. p. 42.

the benefit until 1992 and assume that it got beneficial ownership of the premiums received at the time of their receipt in 1894–1905.

At that time the Interstate Commerce Commission was not interfering with petitioner's bookkeeping. The premiums were entered in a capital account entitled "Premium on Bonds."[1] Not being capital contributed by stockholders, presumably the premiums must have been income before they became capital. They were not borrowed money, for there was no obligation to repay them.

The Interstate Commerce Commission, for the purpose of fixing rates, evolved a system of bookkeeping which it imposed on the petitioner **over its protest.** The Commission required the petitioner to set up new accounts and amortize the premiums over the life of the bonds. If the petitioner had known that these accounts would (years later) be regarded as controlling for income tax purposes, it would probably have litigated the right of the Commission to compel it (a non-operating road which made no rates) to report as income in subsequent years something which it had previously realized. But, since rates made by the Commission could not affect the rents it would receive from the New Haven, it decided that it was cheaper to comply than to contest the ruling.

The Government tries to give the impression that the petitioner treated a part of the premiums on its books as income for 1921. On page 16 the Government's brief so states, with a qualification only mentioned in a footnote. The fact is that the petitioner on its books did not treat any part of the premiums as income for 1921. It merely transferred a part from one capital account ("Bond Premiums") to another capital account ("Profit and Loss"). Moreover, a charge or credit to "Profit and Loss" on books kept under the direction of the

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[1] R. p. 45.

Interstate Commerce Commission may deal with an item actually realized for income tax purposes in an earlier year. This is exemplified in the *Kansas City Southern* case cited below.

Now the Treasury insists that because the Interstate Commerce Commission, for its general purposes, requires the petitioner (for whom no rates are fixed, because it operates no railroad) to amortize the premiums in its returns to the Commission—those premiums, received in 1894–1905, become income taxable in 1921.

The controlling effect of the accounts kept under the supervision of the Interstate Commerce Commission is a point on which the Treasury usually takes the opposite position. *Kansas City Southern Ry. Co.* v. *Commissioner*, 16 B. T. A. 665, was a case where the taxpayer, having, in 1909, abandoned certain property in the process of improving its road, was required by the Interstate Commerce Commission to charge the cost of such property to operating expenses and was permitted to spread the deduction over fifteen years. Aliquot parts of the cost being thus charged off in 1918 and 1919, the taxpayer claimed deductions therefor on its income tax returns. The Treasury Department insisted that Interstate Commerce accounting could not control for purposes of the income tax and was upheld by the Board. On appeal the Circuit Court of Appeals for the Eighth Circuit affirmed the Board and upheld the Treasury Department,[1] saying, inter alia:

> "The Commission did not purport, in requiring the loss for abandonment to be charged to operating expenses to provide any standards for tax authorities to follow. This would be beyond its province. * * * Systems of accounting for railroads under the control of the Commission cannot interfere with the Government's system of

[1] — Fed. (2d) —, Aug. 31, 1931.

taxation. The Commission has no power to direct how the Revenue Laws of the United States shall be interpreted or by its orders provide standards to govern the taxing authorities."

As the Board of Tax Appeals said in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, 1027:

> "We can see no merit in the respondent's action in so far as it is dependent upon the manner in which the account is reflected upon the books. Bookkeeping entries can not control over the actual facts, and if necessary they should be corrected to correspond with the true facts. If the bond discount is to be disallowed as a deduction the denial must rest on more substantial grounds."

The Interstate Commerce Commission, for rate making purposes, allows railroads to deduct their income taxes in computing their income. The Treasury Department always disallows this deduction.

In *Fall River Electric Light Co.* v. *Commissioner*, 23 B. T. A. 168, the taxpayer was under control of the Massachusetts Department of Public Utilities. Under the rules of that Department, the taxpayer was permitted to elect whether to treat bond premiums as income in the year of sale, in the year of maturity, or ratably over the life of the bonds. It elected to treat them as income in the year of maturity. But the Treasury Department insisted on disregarding the books of account, approved by the controlling State Department, and taxed the premiums as income ratably over the life of the bonds. It was upheld by the Board.

CONCLUSION

The Regulations treat bond premiums as income. The Treasury and the petitioner agreed that this was sound, but the petitioner contended that such income, received before March 1, 1913, was not taxable. The Circuit Court of Appeals so held. Now the Government, despite its denial of doing so, repudiates the Regulations and urges that the premiums are not income, offering a new theory that conflicts with the statute permitting the deduction of "all interest."

Although repudiating the theory of the Regulations in order to reach income realized before March 1, 1913, the Government falls back, in its "Conclusion," upon the proposition that the Regulations have been uniformly applied to billions of dollars of railroad indebtedness. But the Government neglects to mention that all but a very small part of those billions are represented by bonds sold after March 1, 1913, bonds sold at par, bonds sold at discounts, and especially bonds issued in exchange for property, where the question before this Court is in no way involved.

The Government, in the last paragraph of its brief, would have this Court believe that the decision of this case will affect bonds to be issued in the future. Nothing could be further from the truth. The Regulations unquestionably apply to all bonds issued after March 1, 1913.

The decision of the Circuit Court of Appeals should be reversed.

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	3
Memorandum	4
Conclusion	8

CITATIONS

Cases:

Chicago, R. I. & P. Ry. Co. v. *Commissioner*, 47 F. (2d) 990; No. 78, Oct. Term, 1931 5

Old Colony R. R. Co. v. *Commissioner*, 6 B. T. A. 1025; affirmed 26 F. (2d) 408; 278 U. S. 592; 279 U. S. 876 ..... 3, 4, 5

Western Maryland Ry. Co. v. *Commissioner*, 33 F. (2d) 695 7

Statute:

Revenue Act of 1921, c. 136, 42 Stat. 227, 254, Sec. 234 (a) (2) 2

78776—31

In the Supreme Court of the United States

OCTOBER TERM, 1931

No. 349

OLD COLONY RAILROAD COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The respondent does not oppose the petition.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 49–60) is reported in 18 B. T. A. 267. The opinion of the Circuit Court of Appeals (R. 73–75) is reported in 50 F. (2d) 896.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 10, 1931. (R. 75–76.) The peti-

tion for a writ of certiorari was filed September 3, 1931. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where the taxpayer sold its bonds at a premium prior to March 1, 1913, did the Commissioner of Internal Revenue properly reduce the amount of the deduction allowed the taxpayer on account of interest paid on these bonds during the calendar year 1921 by an amortized portion of the premium it had received?

STATUTE INVOLVED

Section 234 (a) (2) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 254, provides as follows:

> SEC. 234 (a). That in computing net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * *
>
> (2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; * * *.

STATEMENT

During the years 1895 to 1904 the petitioner issued and sold its bonds in considerable sums, receiving therefor, in addition to the face amount of the bonds, premiums aggregating $199,528.08. (R. 44.) These premiums were credited to a "premium on bond" account and remained there undisturbed until 1914, when the Interstate Commerce Commission required the petitioner to amortize these premiums over the periods of the respective lives of the bonds. For each year subsequent to 1914, the petitioner reported to the Interstate Commerce Commission a ratable proportion of these premiums as income. On its books in each such year the petitioner credited such proportion of the premiums to its profit and loss account, and not to its income account. The amount so credited to profit and loss for the year 1921 was $6,960.64. (R. 45.)

In its income-tax return for the calendar year 1921 the petitioner deducted from gross income the entire amount of interest paid on these bonds. The respondent decreased the amount of this deduction by the amount of the amortized bond premium, $6,960.64, thus increasing the petitioner's taxable income for the year 1921 by this amount. (R. 45.)

The Board of Tax Appeals, on the authority of its decision in the case of the same taxpayer for the preceding tax year (*Old Colony Railroad Co.* v. *Commissioner*, 6 B. T. A. 1025), and the affirmance

of that decision by the Circuit Court of Appeals for the First Circuit (26 F. (2d) 408), held that no part of the premiums in question could be included as part of the income of the petitioner in 1921. On a petition to review brought by the Commissioner of Internal Revenue, the decision of the Board of Tax Appeals was reversed by the Circuit Court of Appeals for the First Circuit. (R. 73–75.)

MEMORANDUM

In a previous case involving the same taxpayer, *Commissioner* v. *Old Colony R. R.*, 26 F. (2d) 408, the same Circuit Court of Appeals which decided the case at bar held that premiums received by the taxpayer upon the sale of its bonds prior to March 1, 1913, should not be amortized over the life of the bonds and a pro rata part returned as accrued income for the year 1920, the taxpayer being on the accrual basis. A petition for a writ of certiorari filed by the Commissioner was granted. (278 U. S. 592.) In this petition and in the Government's brief on the merits it was pointed out that while *in form* the Commissioner treated the amortized premiums as income for 1920, *in fact* he subtracted from the total interest payments to bondholders which were deducted from gross income the exact amount by which such interest payments had been increased by reason of premiums paid at the time the bonds were sold. But the case had not been tried on that theory in the courts below and upon

examination of the record it was found that it failed to disclose the amount of interest payments which had been deducted. Hence the Commissioner filed a motion to dismiss which was granted. (279 U. S. 876.)

The instant case relating to the year 1921 involves the same long-term bonds. The amount of interest paid to bondholders is disclosed by the record (R. 64–67) and the question presented to the Board of Tax Appeals upon motion for reconsideration to the Circuit Court of Appeals and to this Court is whether the part of the amortized premiums applicable to the year 1921 should be treated as offsetting amortized interest paid to the bondholders during that year in determining the deduction allowed under Section 234 (a) (2) of the Revenue Act of 1921 (*supra*, p. 2), which represents a payment in part of such premium. The Circuit Court of Appeals held that it should be so treated and in so doing stated that in the earlier case its attention had not been called to the fact that the premium was not being taxed but was merely being used to offset the interest deduction. (R. 74–75.)

A conflict is claimed between the decision in this case and the decision of the Circuit Court of Appeals for the Seventh Circuit in the case of *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990, in which a petition for certiorari and a brief in opposition have been filed, No. 78, October

Term, 1931. In that case, it was held *inter alia* that a pro rata part of expenses incurred in the years 1904 to 1908 in connection with the issuance and sale of certain long-term bonds could not be deducted in income-tax returns for the years 1916 to 1919, inclusive.

We believe that the question of allowing such expenses to be amortized and deducted over the life of the bonds is totally different from the question of allowing a pro rata part of amortized bond premiums to be offset against interest deductions. There is no relation between such expenses and the calculation of interest. They do not enter into the transaction between the lender and the borrower at all, whereas the premium is paid by the lender for the obligation of the taxpayer to pay a rate of interest higher than the rate at which the bonds could be sold on the market at par upon the assurance that the premiums will be repaid dollar for dollar in installments and in the form of excess interest on the face of the bonds. For taxation purposes the problem reduces itself to the matter of allowing the taxpayer to deduct so much of the interest paid to bondholders as equals the effective interest rate, the balance constituting a repayment of the premium. Thus, while the Circuit Court of Appeals in the Seventh Circuit relied upon the earlier *Old Colony Railroad Company* case in deciding the deductibility of the expenses incurred in selling bonds

prior to March 1, 1913, there is not in fact a conflict between the *Chicago, R. I. & Pacific Company* case and the case at bar. In that connection attention is called to the fact that amortization of bond discount, which is more closely analogous to bond premium, had been allowed to the *Chicago, Rock Island and Pacific Railway Company* and was not questioned. See also *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C. C. A. 4th).

Notwithstanding the absence of a direct conflict, we feel now, as was felt when application was made for certiorari in the former *Old Colony Railroad* case, that the question is one of sufficient importance for review by this Court. In the petition filed in that case it was stated that the aggregate bonded indebtedness of American carriers who uniformly maintain a system of accrual accounting amounted to $10,811,943,274 on January 1, 1918, that most of this indebtedness was represented by long-term bonds issued either at a premium or discount, and that the effect of such premium and discount on income should be authoritatively settled. The amount of such indebtedness had increased to $11,456,596,390 as of December 31, 1930.[1] Consequently, the question is no less important now than it was at the time that the former petition was filed.

[1] Interstate Commerce Commission's Annual Report of the Statistics of Railways of the United States for the year ending December 31, 1930 (not in print September 30, 1931).

CONCLUSION

While we believe that the decision of the Circuit Court of Appeals in the instant case is correct, we do not oppose the petition.

Respectfully submitted.

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No. 349

In the Supreme Court of the United States

OCTOBER TERM, 1931

OLD COLONY RAILROAD COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes, regulations, etc., involved	2
Statement	2
Summary of argument	6
Argument:	
I. Section 234 (a) (2) of the Revenue Act of 1921 did not permit the petitioner to deduct from gross income, as interest paid on its indebtedness, that portion of a so-called annual "interest" payment on certain long-term bonds which represented a pro tanto repayment of a premium received by the petitioner upon the issuance of the bonds	8
II. The petitioner's books, kept on the accrual basis, accurately reflected its true income for 1921, and the Commissioner properly computed the tax on the basis of the net income as shown by such books	16
III. The Commissioner was required by the regulations to prorate or amortize the premiums over the life of the bonds. No constitutional objection arises from the fact that the bond premiums here in question were received prior to March 1, 1913	21
IV. The principle for computing net income which the Commissioner employed in the instant case has been approved by the courts and by the Board of Tax Appeals	26
V. The contention of the Government is not affected by the fact that the petitioner's lessee was obligated to pay the principal of and interest on the bonds in question	36
Conclusion	38
Appendix (Statutes and regulations involved, extracts from the accounting classifications of the Interstate Commerce Commission, and excerpts from accounting texts)	40–52

CITATIONS

Cases: Page

American National Co. v. *United States*, 274 U. S. 99 32
Baldwin Locomotive Works v. *M'Coach*, 221 Fed. 59 32
Barclay & Co. v. *Edwards*, 267 U. S. 442 25
Block v. *Hirsh*, 256 U. S. 135 25
Boston Terminal Co. v. *Gill*, 246 Fed. 664 37
Brushaber v. *Union Pac. R. R. Co.*, 240 U. S. 1 23
Chicago & Alton R. R. Co. v. *United States*, 53 C. Cls. 41 32
Chicago & Northwestern Ry. Co. v. *Commissioner*, 22 B. T. A. 1407 28
C., R. I. & P. Railway Co. v. *Commissioner*, 13 B. T. A. 988, affirmed, 47 F. (2d) 990 (C. C. A. 7th), certiorari denied October 12, 1931, No. 78, October Term, 1931 ..... 27, 29, 33, 34, 35
Cloquet Co-operative Society v. *Commissioner*, 21 B. T. A. 744 10
Connecticut & Passumpsic Rivers Railroad Co. v. *Commissioner*, 24 B. T. A. 394 28–29
Doyle v. *Mitchell Bros. Co.*, 247 U. S. 179 ..... 20, 33
Duffy v. *Central R. R.*, 268 U. S. 55 32
Eisner v. *Macomber*, 252 U. S. 189 21
Fall River Electric Light Co. v. *Commissioner*, 23 B. T. A. 168 28
Flint v. *Stone Tracey Co.*, 220 U. S. 107 25
Galatoire Bros. v. *Lines*, 23 F. (2d) 676 31
Goodrich v. *Edwards*, 255 U. S. 527 33
Hamilton Company v. *Massachusetts*, 6 Wall. 632 25
Hays v. *Gauley Mt. Coal Co.*, 247 U. S. 189 33
Home Ins. Co. v. *New York*, 134 U. S. 594 25
Kentucky River Coal Corporation v. *Lucas*, 51 F. (2d) 586 10
Kentucky River Coal Corporation, Appeal of, 3 B. T. A. 644 10
Kentucky Tobacco Products Co. v. *Lucas*, 5 F. (2d) 723 23
Lynch v. *Turrish*, 247 U. S. 221 33
Manhattan Company v. *Blake*, 148 U. S. 412 26
Merchants' L. & T. Co. v. *Smietanka*, 255 U. S. 509 33
McCoy-Garten Realty Co. v. *Commissioner*, 14 B. T. A. 853 10
New York Ins. Co. v. *Edwards*, 271 U. S. 109 32
Old Colony Railroad Co. v. *Commissioner*, 6 B. T. A. 1025, affirmed, 26 F. (2d) 408, dismissed, 279 U. S. 876 ..... 23, 27, 28, 35
Peck & Co. v. *Lowe*, 247 U. S. 165 25
Provident Institution v. *Massachusetts*, 6 Wall. 611 25
Shaffer v. *Carter*, 252 U. S. 37 25
Southern Pacific Co. v. *Lowe*, 247 U. S. 330 33
Society for Savings v. *Coite*, 6 Wall. 594 25
Stanton v. *Baltic Mining Co.*, 240 U. S. 103 23
Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113 25
United States v. *Childs*, 266 U. S. 304 9
United States v. *Anderson*, 269 U. S. 422 32

Cases—Continued. Page

United States v. *Boston & M. R. R. Co.*, 279 U. S. 732 37
United States v. *Yale & Towne Mfg. Co.*, 269 U. S. 442 32
U. S. Glue Co. v. *Oak Creek*, 247 U. S. 321 25
Western Maryland Ry. Co. v. *Commissioner*, 33 F. (2d) 695 ..... 29, 35
West Music Co. v. *Commissioner*, 14 B. T. A. 158 10

Statutes:
Revenue Act of 1916, c. 463, 39 Stat. 756, 767—
Section 12 (a) Third 25
Revenue Act of 1921, c. 136, 42 Stat. 227—
Section 212 (b) 18, 40
Section 213 ..... 18, 40
Section 230 40
Section 232 40
Section 233 40
Section 234 (a) 41

Regulations:
Treasury Regulations 45, issued under the Revenue Act of 1918:
Article 544 43
Article 564 9
Article 848 ..... 14, 43
Treasury Regulations 62, issued under the Revenue Act of 1921—
Article 545 ..... 21, 41
Article 564 9
Article 848 ..... 14, 43
Treasury Regulations 65, issued under the Revenue Act of 1924—
Article 545 43
Article 564 10
Treasury Regulations 69, issued under the Revenue Act of 1926—
Article 545 43
Article 564 10
Treasury Regulations 74, issued under the Revenue Act of 1928—
Article 68 43
Article 141 10

Miscellaneous:
Accounting, Practice and Procedure, by Arthur Lowes Dickinson, pp. 66, 134 50
Accounting, Theory and Practice, by Roy B. Kester, pp. 367–368 11–12
Accounts in Theory and Practice, by Earl A. Saliers, pp. 171–172 51–52
Classification of Income, Profit, and Loss, and General Balance Sheet Accounts for Steam Roads, prescribed by the Interstate Commerce Commission, effective July 1, 1914, pp. 11, 13, 15, 18, 19, 23, 29, 35, 37, 39, 40 45–50

Miscellaneous—Continued. Page

General Balance Sheet Statement as prescribed by the Interstate Commerce Commission for steam roads in accordance with Section 20 of the Act to Regulate Commerce, First Revised Issue, effective June 15, 1910, pp. 23, 31 ..... 19, 44

Modern Accounting, by Henry Rand Hatfield, pp. 187–188 .. 12–13

Thirty-first Annual Report of Interstate Commerce Commission on Statistics of Railways of the United States for the Year Ending December 31, 1917, pp. 34–36, 54–56 ... 39

Yale Law Journal, Vol. 41, p. 280 16

In the Supreme Court of the United States

OCTOBER TERM, 1931

No. 349

OLD COLONY RAILROAD COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Board of Tax Appeals (R. 40–60) are reported in 18 B. T. A. 267. The opinion of the Circuit Court of Appeals, reversing the decision of the Board (R. 73–75), is reported in 50 F. (2d) 896.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 10, 1931. (R. 75.) Petition for certiorari was filed September 3, 1931, and granted October 26, 1931. (R. 77.) The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under the accrual system of accounting, the amount of the premium received on the sale of long-term corporate bonds, issued by the petitioner prior to 1904 and outstanding during 1921, may be amortized over the life of the bonds, and the amortized portion of such premium applicable to 1921 be included in the petitioner's gross income in that year for the purpose of reducing the amount of the "interest paid" deduction, claimed by the petitioner under Section 234 (a) (2) of the Revenue Act of 1921, to the extent that the asserted amount of "interest paid" represents a repayment in part of the premium.

STATUTES, REGULATIONS, ETC., INVOLVED

The applicable provisions of the Revenue Act of 1921 and the Treasury Regulations, excerpts from the Interstate Commerce Commission's classifications of accounts and form of General Balance Sheet Statement for Steam Roads, and excerpts from various accounting texts, are set forth in the Appendix, pp. 40–52, *infra*.

STATEMENT

The petitioner is, and was during 1921, a Massachusetts corporation. (R. 42.) It kept its accounts upon the accrual basis. (R. 49.)

By a lease dated February 15, 1893, which was in force during 1921, the petitioner leased its railroad lines and all other property to the New York,

New Haven & Hartford Railroad Company, hereinafter referred to as the "New Haven," for a term of 99 years. (R. 42.) Under the lease the New Haven agreed to operate and maintain the petitioner's railroad during the term of the lease, to assume the payment of the principal of and interest upon the petitioner's bonded indebtedness and other obligations, and to pay annually, as rental, a sum equal to a specified rate of dividends upon the capital stock of the petitioner.[1]

During the years 1895 to 1904, inclusive, and while the above-described lease was in force, the petitioner issued and sold certain long-term bonds, and received therefor, in excess of the par value thereof, premiums aggregating $199,528.08. These bonds were outstanding during 1921. (R. 44.)

The record does not indicate what use was made by the petitioner of these premiums or how they were treated by the petitioner in its accounts, save that they were credited on the petitioner's books to an account designated as "Premium on Bond." (R. 44–45.) The credits thus entered remained undisturbed until 1914, when the petitioner was required by the Interstate Commerce Commission "to amortize such premiums over the periods of the respective lives of the bonds." (R. 45.) The peti-

[1] A copy of the lease was attached to the petitioner's petition to the Board of Tax Appeals, as Exhibit B. (R. 16–22.) The findings of the Board incorporated the terms of the lease by reference. (R. 42, 73.)

tioner complied with this requirement under protest. The ratable proportion of the premiums applicable to the years prior to 1914 was extinguished by appropriate entries, and, for 1914 and thereafter, the petitioner reported to the Interstate Commerce Commission as income a yearly ratable proportion of the remainder of these premiums. This yearly sum was entered on its books as a credit to profit and loss (a surplus account) and not to its income account. The proportion of the premiums attributable to the year 1921 and reported to the Interstate Commerce Commission as income for that year was $6,960.64. (R. 45.)

During 1921 the New Haven paid to the bondholders of the petitioner the sum of $538,920 as interest on the bonds in question. (R. 64.) The bonds were the direct obligation of the petitioner to the owners of the bonds and no agreement has ever been executed between the petitioner and the bondholders releasing the petitioner from such direct liability.[2] (R. 64–65, 66–67.)

In its income-tax return for the year 1921 the petitioner included the sum of $538,920 as an item of gross income and took a deduction from gross income of a like amount as interest paid during the year. (R. 65.) It thus did not include in its return for 1921 as taxable income the sum of $6,960.64 above described.

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[2] The amended findings of the Board set forth the provisions of the bonds as to the payment of principal and interest. (R. 65–66.)

The Commissioner, in auditing the petitioner's return for 1921 made no adjustment with respect to either the inclusion of $538,920 in gross income or the deduction of $538,920 therefrom, except to increase taxable income for the year by adding to the petitioner's gross income the sum of $6,960.64. (R. 45, 65.) Upon petition for redetermination of the deficiency found by the Commissioner, the Board, upon the authority of its prior decision in *Old Colony Railroad Co.* v. *Commissioner,* 6 B. T. A. 1025, affirmed, 26 F. (2d) 408 (C. C. A. 1st), held that the Commissioner erred in treating the $6,960.64 item of amortized premium as taxable income for 1921. (R. 50.) The Commissioner filed a motion for reconsideration on the ground that the Board had not considered the question presented by the record whether the amortized portion of the premiums applicable to 1921 should be considered in determining the amount of the interest deduction of the petitioner for that year. (R. 62–63.) This motion was denied. (R. 67.) Upon petition for review the Circuit Court of Appeals reversed the decision of the Board.[3] (R. 76.)

[3] In a previous case involving the petitioner's tax liability for the year 1920, the same Circuit Court of Appeals held that an amortized amount of the premiums received by the petitioner upon the sale of its bonds prior to March 1, 1913, should not be included in its taxable income for the year 1920. (26 F. (2d) 408.) The Commissioner of Internal Revenue filed a petition for certiorari, which was granted. (278 U. S. 592.) In this petition and in the Government's brief on the merits it was pointed out that while

SUMMARY OF ARGUMENT

Section 234 (a) (2) of the Revenue Act of 1921, which permits a taxpayer to deduct from gross income "All interest paid or accrued within the taxable year on its indebtedness," does not permit the deduction of that portion of a so-called "interest" payment which represents a pro-tanto repayment of a premium received upon the issuance and sale of bonds of the taxpayer.

A premium received on the sale of a bond is not in reality income, since it must be repaid, dollar for dollar, on a compound-interest basis, in amortized installments over the life of the bonds and in the form of *excess interest* carried by the bonds. That part of the annual "interest" payment which represents the repayment in part of the money received as a premium is not "interest" within the meaning of the statute, and is not deductible from gross income. The bookkeeping formula, under the accrual system of accounting, for preventing such deduction is to add to gross income for each year a sum equal to that part of the annual "interest" payment for that year which represents a

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in form the Commissioner treated the amortized portion of the premiums as income for 1920, in substance he reduced the amount of the deduction for interest claimed by the petitioner to the extent of such amortized portion of the premiums. But the case had not been tried upon that theory in the courts below, and upon an examination of the record it was found that it failed to disclose the amount of the interest deduction which had been claimed by the petitioner. The Commissioner thereupon filed a motion to dismiss the case, which was granted. (279 U. S. 876.)

repayment in part of the premium. This adjustment brings the interest on the bonds, which is properly deductible from gross income, to the *effective rate*, or that rate at which the bonds could have been sold at par; and the principle is equally applicable whether the bonds have been sold at a premium or at a discount.

The above principles were applied in the case at bar. The amortized portion of the premiums applicable to the year 1921 was treated as an item in the petitioner's gross income for that year for the purpose of offsetting and equalizing that part of the asserted "interest" on the bonds which represented a repayment in part of premiums, and which was not properly deductible as the cost attributable to the earning of that income.

The Revenue Act of 1921 permitted the petitioner to account in 1921 for an amortized portion of the premiums received on the sale of its bonds prior to 1904. It kept its books on the accrual basis and did so account for such portion. The Commissioner was required by the Act to compute the petitioner's net income in accordance with its own method of accounting, if that method reflected its true income. The petitioner's books, kept on an accrual basis, accurately reflected its true income for 1921, and the Commissioner properly computed the tax on that basis.

The petitioner's true net income should be determined for the taxable year 1921 by limiting the

deductions for that year to such costs and expenses, including interest paid, as are properly attributable to the earning of such income. This is, in effect, what the Commissioner did, and the validity of his act is to be judged, not by its form, but by what it accomplished.

The decision in the instant case is not contrary to the decisions of this Court which hold that Congress, under the Sixteenth Amendment to the Constitution of the United States, can not tax as income a gain which accrued prior to the effective date of the Amendment. To so hold would subvert the substance of the transactions here involved to mere matters of form.

The correctness of the action of the Commissioner and the decision of the court below are not affected by the fact that petitioner's lessee has assumed the payment of the principal of and interest on the bonds in question.

ARGUMENT

I

SECTION 234(a)(2) OF THE REVENUE ACT OF 1921 DID NOT PERMIT THE PETITIONER TO DEDUCT FROM ITS GROSS INCOME, AS INTEREST PAID ON ITS INDEBTEDNESS, THAT PORTION OF A SO-CALLED ANNUAL "INTEREST" PAYMENT ON CERTAIN LONG-TERM BONDS WHICH REPRESENTED A PRO-TANTO REPAYMENT OF A PREMIUM RECEIVED BY THE PETITIONER UPON THE ISSUANCE OF THE BONDS

The Government contends that the petitioner, in computing its net income for 1921, was not entitled to deduct from gross income the entire amount,

$538,920, paid in that year as "interest" on its bonds, but *only that amount less $6,960.64,* the latter amount being the amortized portion applicable to 1921 of the premium received by the petitioner upon the sale of the bonds. The Government contends that to the extent of $6,960.64 the payment of $538,920 was not a payment of "interest" but a pro tanto return of the premium, i. e., a repayment of part of the capital fund received upon the sale of the bonds, and as such, we submit, it was not deductible from gross income as "interest."

Section 234 (a) (2) of the Revenue Act of 1921, p. 41, *infra,* permitted the petitioner to deduct from gross income "All interest paid or accrued within the taxable year on its indebtedness." This Court has refused to give the word "interest," as used in tax and other statutes, a peremptory definition. *United States* v. *Childs,* 266 U. S. 304, 307. The Treasury Department, the Board of Tax Appeals, and the courts have consistently ruled that something which is called interest but which is in reality something else does not fall within the interest deduction permitted by the various revenue acts. Thus, Article 564 of Regulations 45 (1920 Ed.), issued under the Revenue Act of 1918, provided that—

> So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at net income.

This provision was carried into Article 564 of Regulations 62, issued under the Revenue Act of

1921, the statute applicable to the instant case, and it has been continued in the subsequent regulations.[4] See also *Kentucky River Coal Corp.* v. *Lucas*, 51 F. (2d) 586 (W. D. Ky.); *Cloquet Co-operative Society* v. *Commissioner*, 21 B. T. A. 744; *McCoy-Garten Realty Co.* v. *Commissioner*, 14 B. T. A. 853; *West Music Co.* v. *Commissioner*, 14 B. T. A. 158; *Appeal of Kentucky River Coal Corporation*, 3 B. T. A. 644.

Since, obviously, the right to the interest deduction provided by the statute is not determined merely by the fact that a payment is designated by the taxpayer as "interest," an inquiry as to the true character of the payment in the instant case is required, and it is pertinent to consider the nature of bond premiums, the conditions under which they are paid, and their relation to and effect upon the computation of net income.

When the bonds in question were issued there was a rate of interest at which they could have been sold on the market at par. This rate is known as the *effective rate*. Because the petitioner was willing to pay a higher or *excess rate* of interest, it was able to sell the bonds at a premium. This premium was not, in essence, income but a lump payment made in return for the obligation, which the petitioner assumed, to pay such higher or excess rate

[4] See Article 564 of Regulations 65, issued under the Revenue Act of 1924; Article 564 of Regulations 69, issued under the Revenue Act of 1926; and Article 141 of Regulations 74, issued under the Revenue Act of 1928.

of interest during the life of the bonds. The premium represented the present value, as of the date of sale of the bonds, of the annual payments of excess interest which the petitioner agreed to make during the life of the bonds. The premium is thus repaid dollar for dollar in annual installments, which, for convenience, may be called excess interest.

The propositions set forth in the preceding paragraph are amply sustained by modern accounting authorities. Thus, in Kester, "Accounting, Theory, and Practice," it is said (pp. 367–368):

> At practically any time in the market there is a rate at which the bonds could be sold at par. This rate is known as the effective rate. If a company puts an issue of bonds on the market at a higher rate than this, the market will offer a premium for them. The amount of the premium will be, theoretically, the present value of the periodic sum represented by the difference between the stated bond interest and the effective interest, these periodic payments extending over the life of the bond. In other words, *the premium represents the price paid to buy the additional interest, dollar for dollar, on a compound interest basis. The premium is, therefore, not an earning, an item of income, but is an offset to the excess bond interest.* The portion of it applicable to each period represents the excess interest which deducted from the bond interest shows the real or effective cost of the money borrowed and to be paid back.

> Thus, the bond interest rate based on the money actually received, i. e., par plus premium, is exactly the same as the market or effective rate on par. In other words, the corporation is paying for its actual borrowings simply the current market rate of interest.
>
> It is therefore incorrect to show in the books the cost of the loan at any other figure than the effective interest. The actual periodic payment of interest is, however, at the bond interest rate. This must be brought down to the effective rate by application to it of a portion of the premium which represents the sum paid for the privilege of receiving the higher rate of interest. Similarly, bonds are marketed at a discount when the bond interest rate is lower than the market rate prevailing on similar security at the time the bonds are floated. This may be looked upon as a payment by the company in lump sum to compensate a purchaser for the difference in the income on the bond and what he might obtain on the open market. The discount should be applied, therefore, periodically to bring the cost of the loan up to its true figure, viz, the market or effective rate. (Italics ours.)

Similarly, in Hatfield, "Modern Accounting," it is stated (pp. 187–188):

> As shown in discussing investments, the premium paid on a bond is virtually the price paid for the privilege of receiving nominal interest at a rate higher than the market

rate. *Viewing the transaction from the borrower's point of view, the premium received is, therefore, a lump payment made in return for the obligation to pay an excessive rate of interest during the life of the bond.* If the credit of the company and the conditions of the market would have enabled the company to issue a five per cent twenty-year bond at par, its six per cent bond, running at the same time, should sell at approximately 112.46. This premium of 12.46 is, therefore, the present value of the annuity of one per cent which the company must pay for 20 years but *the interest installments as paid are normally and properly charged off as an expense and consequently the 12.46 per cent should be spread over all the years during which the interest is thus paid, in order properly to equalize the profits of the several years.* The correct entry, therefore, is to credit the premium received to "Premium on Bonds Issued" a part of which is annually written off to offset the interest paid the bondholders * * *.

Exactly the same principle applies to bonds issued at a discount, just as the same principle applies to bonds bought below par. The discount should appear at first among the assets, but should gradually be written off as the years pass, thus making the annual charge to interest correspond to the real rather than the nominal rate paid. (Italics ours.)

Excerpts from other accounting authorities similar to the foregoing are set forth in the Appendix, pp. 50–52, *infra*.

The views as to the essential nature of bond premiums and bond discounts set forth in the above quotations are reflected in the regulations of the Treasury Department. Thus, Article 848 of Regulations 45, issued under the Revenue Act of 1918, and Article 848 of Regulations 62, issued under the 1921 Act, dealing with the invested-capital provisions, provided:

> ART. 848. *Surplus and undivided profits: discount on sale of bonds.*—Discount allowed on the sale of bonds is in effect an advance on account of interest so that the effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a property account or otherwise incorrectly carried as an asset, and is so reflected in the surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount.

In the instant case the petitioner's liability to pay excess interest, by reason of the issuance of the bonds at a premium, continued throughout 1921. The question at issue, as the Government views the case, is whether that part of the "interest" payment, so called, made in 1921, which rep-

resented a repayment in part of the premium, could properly be claimed by petitioner as a deduction from its gross income for that year as a cost or expense properly attributable to the earning of that income. We contend that this was not a proper deduction, and that in determining the petitioner's true net income for 1921 it was necessary, as was done by the petitioner on its books, to offset the excess interest paid in that year—which represented a repayment in part of the premium—by the amortized portion of the premium applicable to that year.

By Section 234 (a) (2) of the Revenue Act of 1921 the petitioner was allowed to deduct from its gross income "All *interest* paid or accrued within the taxable year on its *indebtedness.*" The real "indebtedness" of the petitioner on the bonds here in question is the aggregate of the face value of the bonds. The interest on this indebtedness, which is clearly what the statute contemplates, is interest thereon at the *effective rate,* or that rate at which the bonds would have been sold at par rather than interest at the *nominal rate* set forth in the bonds themselves, the latter rate in reality, under proper accounting rules, representing in part a return of the borrowed capital. Accordingly, we contend that the "interest" payable on the petitioner's bonds in excess of the effective rate is not interest on indebtedness within the meaning of the statute, but simply a repayment in accurately computed yearly installments on a compound interest basis

of the money obtained as a premium when the bonds were issued; and the time over which the bonds are to run is as much a factor in the repayment of this money as the rate of excess interest itself. We submit that any sum, though called interest, which represents in fact a repayment of bond premium, and thus a repayment of part of the borrowed capital, is not a true cost or expense attributable to the earning of income. Nor is it interest on the petitioner's indebtedness, and accordingly the statute does not permit its deduction from gross income. See 41 Yale L. J. 280.

II

THE PETITIONER'S BOOKS, KEPT ON THE ACCRUAL BASIS, ACCURATELY REFLECTED ITS TRUE INCOME FOR 1921, AND THE COMMISSIONER PROPERLY COMPUTED THE TAX ON THE BASIS OF THE NET INCOME AS SHOWN BY SUCH BOOKS

In compliance with the accounting classifications of the Interstate Commerce Commission the petitioner, on its books and in its annual report to the Commission, included as income for 1921 the sum of $6,960.64, being the proportion of the bond premium properly attributable to that year.[5] (R. 45, 65.) Upon comparing the petitioner's tax return for 1921 with its books, the Commissioner found

[5] The Board of Tax Appeals found that for each year after 1914 the petitioner reported a ratable proportion of the bond premiums to the Interstate Commerce Commission as income. (R. 45.) The Board also found that "On its books in each such year petitioner credited such proportion of the premiums to profit and loss account (a surplus account) and

that while the petitioner in its return had claimed as a deduction from gross income the full amount of the asserted "interest" paid on its bonds (R. 65), it had failed in its return to add to its gross income that part of the bond premiums corresponding to the excess interest which the bonds called for in 1921. Accordingly, the Commissioner added the sum of $6,960.64 to the petitioner's gross income for 1921. (R. 65.) In making the necessary adjustment the Commissioner might have refrained from adding the item of $6,960.64 to the petitioner's gross income, as the petitioner did in its 1921 tax return, but it would then have been necessary to reduce by $6,960.64 the amount of the "interest paid" deduction claimed in the petitioner's return.

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not to its income account." (R. 45.) Since under the Interstate Commerce Act the petitioner was required to keep its books pursuant to the accounting classifications of the Commission, it is difficult to reconcile these findings, except upon the assumption that the petitioner failed to follow the accounting classifications of the Commission, which plainly required the petitioner to credit the amounts in question to its income account. (See pp. 19, 45, 49, *infra*.) But for purposes of the income tax the effect of the act of the petitioner in crediting the amounts in question to its profit and loss account, a *surplus* account, was substantially the same as if such amounts had been credited immediately to its income account. If such amounts had been credited by the petitioner directly to its income account, they would thereupon have been reflected in its profit and loss account, since the Commission's classifications prescribed that "The net balance of income (or loss) shall be carried to Profit and Loss." (P. 46, *infra*.) By crediting the amounts in question directly to profit and loss, in plain violation of the accounting rules of the Commission, the petitioner thus merely omitted one step in the usual and prescribed accounting procedure.

But since the same result, *so far as the amount of taxable net income is concerned,* was reflected by the petitioner's books, kept on the accrual basis, the Commissioner, as required by the statute, adopted the method of accounting employed by the petitioner because it reflected the petitioner's true income.

Section 212 (b) of the Revenue Act of 1921, p. 40, *infra,* made applicable to corporations by Section 232, p. 40, *infra,* required that—

> *The net income shall be computed* upon the basis of the taxpayer's annual accounting period * * * *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. (Italics ours.)

The accrual method of reporting income employed by the petitioner was authorized by Section 213 (a) of the Revenue Act of 1921, pp. 40–41, *infra,* which provided with respect to gross income that—

> The amount of all such items * * * shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period:* * * * (Italics ours.)

The form of General Balance Sheet Statement prescribed by the accounting classifications of the Interstate Commerce Commission for steam railroads, pursuant to which the petitioner was required to keep its accounts, provided (pp. 44–45, *infra*):

> When any issue of funded debt is sold at a premium or issued for a consideration the actual money value of which, at the time of the sale of the funded debt, is greater than the par value of the securities sold and accrued interest thereon, if any, the premium so realized should be credited to a ledger account provided for discounts and premiums on the class of funded debt sold. * * * At or before the close of any fiscal period there should *be credited to the Income of that period* (and debited to the Discounts and Premiums accounts in which the premium is carried) such proportions of the premiums on outstanding debt obligations as may be applicable to that period. This proportion may be determined according to a rule the uniform application of which throughout the interval between the date of sale and the date of maturity of the debt will extinguish the premium at which such debt was sold. (Italics ours.)

It will be seen that the Commissioner computed the petitioner's net income for 1921 on the basis of the method of accounting which the petitioner then regularly employed in keeping its books, and which

was necessarily in accordance with rules of the Interstate Commerce Commission designed to reflect accurately the financial condition of the company. That the particular accounting procedure followed by the petitioner was forced upon it by reason of the regulations of the Interstate Commerce Commission is wholly immaterial if, as we contend, the accounting procedure followed by the petitioner accurately reflected its net income. Clearly the Government's right to the correct tax is not to be defeated by the fact that the taxpayer's true income for tax purposes was reflected by a system of bookkeeping which had been found necessary to show its true income for rate-making or other purposes.

From the foregoing it is clear that in form the Commissioner credited the petitioner's gross income for 1921 with the part, applicable to that year, of the premiums which it had received on the sale of its bonds in the years between 1895 and 1904, and thus made the petitioner's return conform to its books. In substance, this amounted to nothing more than one method of eliminating from the petitioner's deductions from gross income in 1921 the excess interest carried by the bonds. The repayment of capital in the form of excess interest is not an expense attributable to the earning of income for the taxable year. The Commissioner's object was to distinguish repayment of capital from deductible expense, just as it is necessary "to distinguish capital previously existing from income taxable under the act." *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 188.

III

THE COMMISSIONER WAS REQUIRED BY THE REGULATIONS TO PRORATE OR AMORTIZE THE PREMIUMS OVER THE LIFE OF THE BONDS. NO CONSTITUTIONAL OBJECTION ARISES FROM THE FACT THAT THE BOND PREMIUMS HERE IN QUESTION WERE RECEIVED PRIOR TO MARCH 1, 1913

Article 545 of Regulations 62, pp. 41–43, *infra*, provided:

> If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds.

The petitioner concedes that these regulations are valid but contends that they are not applicable to a case where, as in the instant case, the premiums were received prior to March 1, 1913. (Pet. Br. 10.) The Government contends that there is no constitutional objection to applying the regulations to premiums received prior to the effective date of the Sixteenth Amendment.

Calling something income does not make it such. See *Eisner* v. *Macomber*, 252 U. S. 189, 206. While concededly the regulations speak of a premium received on the issuance of a corporate bond as "gain or income," in reality, as set forth in Point I, *supra*, such premium is not income any more than the receipt of borrowed money is income. It is, as we have shown, nothing more than a lump payment of money which is to be repaid in installments

in the form of excess interest running over the life of the bond. It is properly *treated as gross income* only for the purpose of offsetting that part of the excess interest, carried by the bond, which represents a return of the borrowed capital, and which is not properly deductible from gross income as "interest paid." But while the phrasing of the regulations may be inept, the intention to amortize bond premiums over the life of the bonds is plain, and the result of the application of the regulations is to reflect the true income of the taxpayer who issues bonds at a premium.

The accounting mechanics authorized by the statute and adopted by the Commissioner are embodied in the accrual system of accounting on which the books of the petitioner were kept. The object to be accomplished was not to tax any part of the premiums as income, but to prevent the deduction from gross income of sums representing a repayment in part of those premiums. Because the books of the taxpayer showed as a charge, deductible from gross income, the whole of the asserted "interest" carried by the bonds as issued, the logical, and indeed the scientific, method of bringing the account to a proper balance was not to change or alter the entries showing interest paid, and thus lead perhaps to confusion as to the meaning of the entries, but to enter as a compensating item on the other side of the account, as income, the exact part of the interest on the bonds which represented a repayment in part of premiums. In this manner the

books were not only kept in proper balance, but the effect was to exhibit true income by preventing a deduction for the taxable year which was not in any sense attributable to the earning of income for that year.

It is thus seen that the gist of the petitioner's complaint is directed at a mere bookkeeping entry, *the true effect of which was merely to prevent an improper deduction from gross income.* What was done was not, therefore, in a field beyond the power of Congress to enter, but in one where its authority stands unchallenged. *Brushaber* v. *Union Pac. R. R. Co.,* 240 U. S. 1; *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103; *Kentucky Tobacco Products Co.* v. *Lucas,* 5 F. (2d) 723 (W. D. Ky.). Standing upon the mere form of the bookkeeping entries, the taxpayer insists that the tax demanded of him is beyond the power of Congress to levy without apportionment. Looking at the substance of what was done, and disregarding the mere form of the entries which reflect that substance, the Government claims that no constitutional question is involved.

In *Commissioner* v. *Old Colony Railroad Co.,* 26 F. (2d) 408, 410 (C. C. A. 1st), which involved the same taxpayer and the same bonds, the court below seems to have been misled by what it regarded as an established fact, that "these premiums when received were regarded and treated as capital and expended in the improvement of its road." There was nothing in the record in that case to support this statement. But even if the

premiums were so treated and used, that fact offers no argument against the respondent's contention herein. On the contrary, it supports it. The capital which was provided *by the premiums* was, just like the rest of the money received upon the sale of the bonds, borrowed capital; but, under the contract of borrowing, this particular part of the borrowed capital was to be repaid during the life of the bonds by annual payments in the form of excess interest. That part of the excess interest for 1921 which represented a repayment of premiums was thus a return of borrowed capital and was not deductible from gross income. The Commissioner was clearly right in excluding such deductions, and this is all that he did.

The court below did not consider that its decision in the instant case was inconsistent with its previous opinion in 26 F. (2d) 408. Speaking of the earlier case, the court said (R. 75):

> The court's attention was not called to the fact that the profit made in the early years was not being taxed, but that it was being used only to determine the expense for the year 1921 of the payment of interest on the bonds. This is not a tax but an allocation, under proper accounting methods for books kept on the accrual basis, of the expense chargeable to the year 1921. See *Chicago, Rock Island & Pacific Ry. Co.*, 13 B. T. A. 989, 1029.

Assuming as a matter of course that it was permissible to limit directly the deduction allowed for

interest,[6] it seems clear that the manner in which this was accomplished is unimportant. Cf. *Block* v. *Hirsh*, 256 U. S. 135, 158. Moreover, once it be understood that the Commissioner was taking the amortized portion of the bond premium applicable to 1921 into consideration only for the purpose of determining the petitioner's interest deduction for 1921, it becomes quite immaterial whether bond premiums constitute income or not, since it is competent for Congress to consider, in the measure of a tax, that which it may not tax directly. Thus, either the Federal or State government may include the tax-exempt bonds of the other in computing excise taxes on corporations for the privilege of doing business in corporate form. *Provident Institution* v. *Massachusetts*, 6 Wall. 611; *Society for Savings* v. *Coite*, 6 Wall. 594; *Hamilton Company* v. *Massachusetts*, 6 Wall. 632; *Home Ins. Co.* v. *New York*, 134 U. S. 594; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107. Likewise, receipts from exports may properly be included in computing a Federal tax. *Peck & Co.* v. *Lowe*, 247 U. S. 165; *Barclay & Co.* v. *Edwards*, 267 U. S. 442. Similarly, the measure of a State tax may include receipts from interstate commerce. *U. S. Glue Co.* v. *Oak Creek*, 247 U. S. 321; *Shaffer* v. *Carter*, 252 U. S. 37; *Underwood T'writer Co.* v. *Chamberlain*, 254 U. S. 113. Congress may tax State banks upon the aver-

[6] See for instance, Section 12 (a) Third of the Revenue Act of 1916, c. 463, 39 Stat. 756, 767. And see cases cited at p. 23, *supra*.

age amounts of their deposits and include for this purpose deposits of State funds. *Manhattan Company* v. *Blake,* 148 U. S. 412.

Upon like principles we think that the inclusion by the Commissioner of the amortized portion of the premiums in petitioner's gross income, rather than the direct reduction of the interest allowance, raises no constitutional question. It is wholly immaterial, therefore, that the premiums in question were received prior to the effective date of the Sixteenth Amendment. Neither that fact nor any other fact shown by the record raises any question of the taxing powers of Congress under the Constitution.

IV

THE PRINCIPLE FOR COMPUTING NET INCOME WHICH THE COMMISSIONER EMPLOYED IN THE INSTANT CASE HAS BEEN APPROVED BY THE COURTS AND BY THE BOARD OF TAX APPEALS

The Board of Tax Appeals in the instant case allowed itself to be misled, by the form in which the bookkeeping entry was made, into a disregard of what in substance the entry accomplished. The Board has since rectified its error, and now holds that both bond premiums and bond discounts must be amortized over the life of the bonds, regardless of the date of the issuance of the bonds.

The ruling of the Board in the instant case was predicated upon its prior ruling as to the petitioner's tax liability for 1920, reported in 6 B. T. A. 1025, where it was held that the premiums received

upon the sale of the bonds in question could not be allocated over the life of the bonds and an allocated part thereof included in the petitioner's gross income each year during the life of the bonds. That decision of the Board was affirmed by the court below in *Commissioner* v. *Old Colony Railroad Co.* 26 F. (2d) 408, upon the ground that the premiums became part of the petitioner's capital prior to the enactment of the Sixteenth Amendment and could not be taxed as income thereafter.

In its previous decision in 6 B. T. A. 1025, *supra*, the Board intimated that if the bonds had been sold at a discount it would have refused to permit the amortization of such discount. Later, in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, it characterized as dictum its statement with reference to discounts in 6 B. T. A. 1025, and allowed the amortization of discounts on bonds sold prior to March 1, 1913.[1] It distinguished the *Rock Island* case from its decision in the previous *Old Colony* case, as follows (pp. 1029–1030):

> What is income is controlled by the Constitution, while *deductions are a statutory concept*. In the years before us, the peti-

[1] Upon petition for review of other issues involved in this case the decision of the Board was affirmed in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 47 F. (2d) 990, certiorari denied, October 12, 1931, No. 78, October Term, 1931. See pp. 34–35, *infra*.

tioner was on an accrual basis for the reporting of income, not only because that was the system necessary to reflect true income, but because the Interstate Commerce Commission required such a basis. Income realized before the adoption of the Sixteenth Amendment may not thereafter be taxed, *but as concerns deductions from income, the same rule does not necessarily apply.* (Italics ours.)

In *Chicago & Northwestern Ry. Co.* v. *Commissioner,* 22 B. T. A. 1407, the Board, following its decision in the first *Old Coloney* case, held that the amortized portion of premiums on bonds issued prior to March 1, 1913, should not be included in the taxpayer's gross income of 1920, but, departing from its decision in the *Old Coloney* case, held that the amortized portion of premiums on bonds issued subsequent to March 1, 1913, should be included in gross income of subsequent years. In *Fall River Electric Light Co.* v. *Commissioner,* 23 B. T. A. 168, the Board held that the Commissioner should not increase taxable income by reducing deductions allowed for interest by a proportionate amount of the premiums received on the sale of bonds in 1925, but that the premiums were income and should be amortized over the life of the bonds.

On October 21, 1931, the Board overruled its earlier decisions and followed the decision of the court below in the instant case. *Connecticut &*

Passumpsic Rivers R. R. Co. v. *Commissioner*, 24 B. T. A. 394, 400. In that case the Board said:

> In the light of the later pronouncement of the same court upon this question, we sustain the Commissioner's regulation and *hold that an aliquot part of the premiums upon bond issues is to be included in the gross income regardless of the date of issue.* (Italics ours.)

Although the court in the instant case held that the deduction for interest paid should be reduced by the aliquot portion of the bond premium allocable to the taxable year, the Board in the case cited said that—

> * * * the result is the same if the aliquot portion of the premium be included in the gross income and the taxpayer is permitted to deduct as an expense the total interest paid on the bond issue during the taxable year.

In *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C. C. A. 4th), the court, following the decision of the Board in the *Rock Island* case, 13 B. T. A. 988, held that where bonds were sold at a discount between 1904 and 1911, such discount could be amortized over the life of the bonds and a proportionate part thereof deducted each year as accrued interest from gross income under Section 234 (a) (2) of the Revenue Act of 1918.

The amortization of bond discounts over the life of the bonds, even where the bonds were issued

prior to 1913, is thus clearly established by decisions of the Board and the courts. But, keeping in mind the nature of a bond premium, it is obvious that, where the taxpayer's books are kept on the accrual basis, the treatment thereof in computing net income should differ in no essential regard from the treatment of bond discounts. If in the case of bond discounts the nominal interest must be corrected to the effective interest, the same reasoning requires the correction of the nominal interest to effective interest in the case of bond premiums. The purpose in either case is to conform the "interest paid" deduction from gross income to interest calculated at the *effective rate* on the amount of money borrowed, regardless of the manner of its receipt or payment.

What the Board of Tax Appeals at first failed to appreciate was that in cases of bond discounts, as well as in cases of premiums, it was in fact dealing with the *same* "statutory concept," i. e., *deductions from gross income.* The application is somewhat different in the two cases but the principle is the same. The object to be obtained in either case is the deduction from gross income of the full amount of interest at the effective rate on the indebtedness created by the issuance of the bonds. This purpose necessarily excludes the deduction as interest, in the case of bonds sold at a premium, of that part of the so-called annual interest payment which is in essence a repayment of money received in the form of premiums. The regulations provide for the amortization of both premiums and discounts,

and a large number of tax settlements have been disposed of on that basis.

In *Galatoire Bros.* v. *Lines,* 23 F. (2d) 676, 677, the Circuit Court of Appeals for the Fifth Circuit had before it a case in which the taxpayer, as consideration for the lease of a certain building for restaurant purposes, had promised to pay the lessor $250 per month during the life of the lease, plus fifty per cent of the profits of the restaurant during the year 1917, and, also, to furnish the lessor and his family with board during that year. The question presented was whether the taxpayer could deduct from gross income for 1917 the fifty per cent of the profits for that year payable to the lessor, as well as the cost of furnishing board to him and his family during that year, or whether these sums should be prorated over the life of the contract and only that part thereof properly applicable to the year 1917 allowed as a deduction. The Government contended for the pro rata deduction, and the court, upholding this contention, said:

> The expenditures in question being in part a consideration for the use of the rented premises after the year 1917, the whole thereof cannot properly be considered "necessary expenses actually paid in carrying on any business or trade" during that year, and only the part thereof properly attributable to the process of earning income during that year was deductible from the gross income for that year.

In *United States* v. *Anderson* and *United States* v. *Yale & Towne Mfg. Co.*, 269 U. S. 422, 440, this Court held that a taxpayer's income for a given taxable year could not be correctly determined without deducting from its gross income for such year the true cost and expenses attributable to the production of income during that year. Cf. *American National Co.* v. *United States*, 274 U. S. 99; *Duffy* v. *Central R. R.*, 268 U. S. 55.

Having in mind the true nature of premiums, the value of these cases as precedents is not lost by reason of the fact that they deal with matters occurring after March 1, 1913.

There are no authorities contrary to the Government's contention. *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109; *Baldwin Locomotive Works* v. *McCoach*, 221 Fed. 59 (C. C. A. 3d); and *Chicago & Alton Railroad Co.* v. *United States*, 53 C. Cls. 41, are not in conflict with the instant case, since the first case involved the Revenue Act of 1913, and the last two cases involved the Corporation Excise Tax Act of 1909, both of which recognized only the cash receipts and disbursements basis for filing tax returns. Another vital distinction between the *New York Life Insurance Co.* case and the instant case is that the former involved the amortization of premiums on bonds of others purchased by the taxpayer, whereas the instant case involves the amortization of premiums on bonds issued by the petitioner. That case is further differentiated from this case by the fact that the

Court there considered only the question whether annual amortization could be taken, not as an offset against interest received, but as a loss "actually sustained within the year." (See *C., R. I. & P. Ry. Co.* v. *Commissioner,* 13 B. T. A. 988, 1033.)

Lynch v. *Turrish,* 247 U. S. 221; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330; *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179; *Hays* v. *Gauley Mt. Coal Co.,* 247 U. S. 189; *Merchants' L. & T. Co.* v. *Smietanka,* 255 U. S. 509; and *Goodrich* v. *Edwards,* 255 U. S. 527, which were cited by the court below in the 1920 case (26 F. (2d) 408), are authority for the proposition that Congress, under the Sixteenth Amendment, can not tax as income a gain which accrued prior to the effective date of that Amendment, even though it was not realized until after that date. But they are not authority for the proposition that where prior to that date a corporation has sold its bonds at a premium and assumed an offsetting obligation to pay excess interest throughout the life of the bonds, Congress may not exclude that part of the annual interest payment which represents a repayment of premiums from the interest deduction it allows to be made from gross income. Nor do these cases hold that where, as in this case, the portion of the annual interest payment representing the repayment of premiums has been deducted as interest, Congress may not require its addition to gross income so as to offset its improper deduction as interest. We know of no decision of this Court which denies

the right of the Commissioner to make such adjustments.

The petitioner contends that the decision of the court below in the instant case is inconsistent with that in *Chicago, R. I. and P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7th), certiorari denied, October 12, 1931, No. 78, October Term, 1931. In that case it was held, *inter alia*, that a pro rata part of expenses incurred in the years 1904 to 1908 in connection with the issuance and sale of certain long-term bonds could not be deducted in the taxpayer's income-tax returns for the years 1916 to 1919, inclusive. Unlike the instant case, that case involved Section 234 (a) of the Revenue Act of 1918, which allowed a deduction from gross income of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," and a similar section in the Revenue Act of 1916, and the Government argued that the expenses in question were not "ordinary and necessary" expenses, that they were not paid or incurred during the taxable years in question, and that they were not incurred "in carrying on any trade or business," since they were not incidental to the current production of income.

Apart from the difference in the applicable sections of the statute, the question of allowing such expenses as were involved in the *Rock Island* case to be amortized and deducted over the life of the bonds is totally different from the question of allowing a pro rata part of amortized bond premiums to

be offset against interest deductions. There is no relation between such expenses and the calculation of interest. They do not enter into the transaction between the lender and the borrower at all, whereas the premium is paid by the lender for the obligation of the taxpayer to pay a rate of interest higher than the rate at which the bonds could be sold on the market at par, upon the assurance that the premium will be repaid dollar for dollar in annual installments and in the form of excess interest stipulated for on the face of the bonds. For taxation purposes the problem reduces itself to the question of allowing the taxpayer to deduct so much of the interest paid to bondholders as equals the effective interest rate, the balance constituting a repayment of the premium. Thus, while the Circuit Court of Appeals for the Seventh Circuit relied upon the first *Old Colony Railroad Company* case in deciding the question of the deductibility of expenses incurred in selling bonds prior to March 1, 1913, there is not in fact a conflict between the *Rock Island* case and the case at bar. In this connection attention is called to the fact that amortization of bond discount, which is more closely analogous to bond premium than the expenses involved in the *Rock Island* case, had been allowed to the Chicago, Rock Island and Pacific Railway Company in the case in question and its allowance was not questioned. See also *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C. C. A. 4th), *supra*.

V

THE CONTENTION OF THE GOVERNMENT IS NOT AFFECTED BY THE FACT THAT THE PETITIONER'S LESSEE WAS OBLIGATED TO PAY THE PRINCIPAL OF AND INTEREST ON THE BONDS IN QUESTION

In Point III of the brief in support of the petition for certiorari, the petitioner argues that even if the Government's contention—that the petitioner is entitled to a deduction for interest paid at the effective interest rate rather than at the nominal interest rate—were sound it would not apply to the instant case, where the bonds were issued at a premium by a lessor corporation under a long-term lease which provided that the lessee should pay the interest fixed by the bonds and redeem them at maturity. The contention of the petitioner apparently is that the bond premiums, whether used for improvements of the railroad or to pay its prior obligations which had been assumed by the lessee, inured primarily to the benefit of the lessee and that the petitioner would secure no benefit therefrom until termination of the lease in 1992. Accordingly, it is argued that in any event the Government would not be "justified *in treating as income*" to the petitioner in 1921 more than "the present value in that year of the right to $6,960.64 receivable in 1992, which on a 4% compound discount basis would be about $445." We submit that the petitioner's contention is wholly without merit.

In the first place it entirely misconstrues the Government's argument, which is that the sum of

$6,960.64 in question *is not income and is not taxed as such.* Accordingly, there is no necessity for establishing that it possesses any of the incidents of income. It is true that the Commissioner, in the petitioner's tax return, included the amount in question as *gross income,* but that was only an accounting device, suggested by the petitioner's own books of account, for determining the correct amount of the statutory interest deduction.

Moreover, it is not true that the bond premium "could not benefit the lessor [petitioner] until the termination of the lease." The payment of the interest due on the petitioner's bonds by its lessee in reality constitutes additional rent on which the petitioner, as lessor, is liable to pay income taxes. *United States* v. *Boston & Maine Railroad,* 279 U. S. 732; *Boston Terminal Co.* v. *Gill,* 246 Fed. 664 (C. C. A. 1st). But although the payment by the lessee of the petitioner's interest obligations on the bonds constitutes gross income of the petitioner, the petitioner—being obligated to pay the bonds and the interest thereon—is entitled to a deduction for the payment of such interest. *Boston Terminal Co.* v. *Gill, supra.* So far as the "interest" payable on the bonds represents true interest, and not the repayment of bond premium, the two transactions exactly offset each other, and no tax results for the petitioner. As far as benefit to the petitioner is concerned, the petitioner is benefited just as much by the lessee's payment of that part of the "inter-

est" payable on the bonds which represents a part repayment of the bond premium, as by the lessee's payment of that part of the annual "interest" payment which represents true interest. In each case the petitioner is benefited by the discharge of its legal obligations.

Furthermore, the petitioner must be taken as having received the benefit of the bond premiums in the instant case, since it received the entire proceeds of the bonds. And even if the bond proceeds were used for improvements of the leased property, which the petitioner can not use until 1992, or for the payment of its prior indebtedness, which was assumed by its lessee, the petitioner in reality began receiving the actual benefit of the premiums immediately upon the issuance of the bonds by reason of the payment by the lessee of rent in excess of the effective interest rate.

CONCLUSION

The method adopted by the Commissioner in computing the petitioner's 1921 net income was in accordance with principles of accounting recognized as sound by leading authorities and by the Interstate Commerce Commission. It reflected accurately the petitioner's financial condition and net income, and was the method actually used by the petitioner in keeping its books and making its reports to the Commission. It was, in essence, in accordance with the Treasury Regulations uniformly followed since the enactment of the Revenue Act of

1918, and applied to the billions of dollars of outstanding indebtedness of American railroads upon long-term obligations. (See Thirty-First Annual Report of Interstate Commerce Commission on the Statistics of Railways in the United States for the year ending December 31, 1917, pp. 34–36, 54–56.) Under such circumstances the determination of the Commissioner should not be disturbed.

Moreover, unless the Commissioner's theory as to the treatment of bond premiums is adopted, it would seem that a corporation, by selling its bonds at a high nominal interest rate so as to produce a premium, could reduce its taxable net income by the amount of the premium and to that extent escape taxation.

The judgment below should be affirmed.

Respectfully submitted.

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JANUARY, 1932.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 252, 254:

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 230. (a) That * * * there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax * * *

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 * * *

SEC. 213. That * * * the term "gross income"—

(a) Includes gains, profits, and income derived from * * * businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items * * * shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *.

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions—

(1) All the ordinary and necessary expenses paid or incurred during the taxable year * * *;

(2) All interest paid or accrued within the taxable year on its indebtedness * * *.

Treasury Department Regulations 62, issued under the Revenue Act of 1921:

ART. 545. *Sale and retirement of corporate bonds.*—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price

or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2) (a) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year.

(3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year.

(c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year.

Article 544 of Treasury Department Regulations 45, issued under the Revenue Act of 1918, Article 545 of Regulations 65, issued under the Revenue Act of 1924, Article 545 of Regulations 69, issued under the Revenue Act of 1926, and Article 68 of Regulations 74, issued under the Revenue Act of 1928, contain substantially the same language as Article 545 of Regulations 62 above quoted.

Treasury Department Regulations 62 also provide:

ART. 848. *Surplus and undivided profits: discount on sale of bonds.*—Discount allowed on the sale of bonds is in effect an advance on account of interest, so that the effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a property account or otherwise incorrectly carried as an asset, and is so reflected in the surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount. See article 563.

Treasury Department Regulations 45, Article 848, is in substantially the same language as Article 848 of Regulations 62.

[Excerpts from accounting orders and classifications of the Interstate Commerce Commission]

The form of General Balance Sheet Statement prescribed by the Interstate Commerce Commission for steam roads, in accordance with Section 20 of the Act to Regulate Commerce, First Revised Issue (effective June 15, 1910) provides (pp. 23, 31):

> *Deferred debit items.*—B 20 (b) Unextinguished Discount on Funded Debts: If the net of the balances in the Discounts and Premiums accounts for all classes of funded debt sold is a debit balance, the amount should be included in this account. At or before the close of each fiscal period, there should be charged to Income (and credited to the Discounts and Premiums accounts in which the discount is carried) such proportions of the discount on outstanding debt obligations as may be applicable to that period. This proportion should be determined according to a rule the uniform application of which throughout the interval between the date of sale and the date of maturity will extinguish the discount on funded debt. In order that the discount may be extinguished earlier the company may, at its option, charge to Profit and Loss all or any portion of the discount on funded debt remaining at any time unextinguished; but the charge to Income for any period must not exceed the proportion applicable to that period and a charge should be made for each period so long as any portion of the discount remains unextinguished.
>
> NOTE A.— * * *.
>
> NOTE B.—In no case should discount on securities be charged to or included in any

account as a part of the cost of acquiring any property, tangible or intangible.

* * * * *

Deferred credit items.—B. 144 Unextinguished Premiums on Outstanding Funded Debt: When any issue of funded debt is sold at a premium or issued for a consideration the actual money value of which at the time of the sale of the funded debt is greater than the par value of the securities sold and accrued interest thereon, if any, the premium so realized should be credited to a ledger account provided for discounts and premiums on the class of funded debt sold. (See account B 20.) If the net of the balances in the Discounts and Premiums accounts for all classes of funded debt sold is a credit balance, the amount should be included in this account. At or before the close of any fiscal period there should be credited to the Income of that period (and debited to the Discounts and Premiums accounts in which the premium is carried) such proportions of the premiums on outstanding debt obligations as may be applicable to that period. This proportion may be determined according to a rule the uniform application of which throughout the interval between the date of sale and the date of maturity of the debt will extinguish the premium at which such debt was sold.

The Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads prescribed by the Interstate Commerce Commission, effective July 1, 1914, provides (pp. 11, 13, 15, 18, 19, 23, 29, 35, 37, 39, 40):

INCOME ACCOUNTS

* * * * *

SPECIAL INSTRUCTIONS

1. *Income accounts defined.*—Income accounts are those designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for the services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of moneys and for use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to Profit and Loss.

* * * * *

I. CREDITS

* * * * *

517. RELEASE OF PREMIUMS ON FUNDED DEBT.

This account shall include, during each fiscal period, such proportion of the premiums on outstanding funded debt as may be applicable to the period. This proportion shall be determined in accordance with special instructions for balance-sheet accounts, section 3.

* * * * *

II. DEBITS

* * * * *

548. AMORTIZATION OF DISCOUNT ON FUNDED DEBT.

This account shall be charged during each fiscal period with the proportion of the dis-

count and expense on funded debt obligations applicable to that period. This proportion shall be determined according to a rule the uniform application of which through the interval between the date of sale and the date of maturity will extinguish the discount and expense on funded debt. The charge to this account for any period must not be either greater or less than the proportion of the balance remaining unamortized applicable to that period so long as any portion of the discount and expense remains unextinguished. (See special instructions for balance-sheet accounts, section 3.)

NOTE.—The accounting company may, at its option, charge to profit and loss account No. 617, "Debt discount extinguished through surplus," all or any portion of the discount and expense on funded debt remaining at any time unextinguished.

* * * * *

PROFIT AND LOSS ACCOUNTS

* * * * *

617. DEBT DISCOUNT EXTINGUISHED THROUGH SURPLUS.

This account shall include appropriations of surplus made, at the option of the accounting company, to reduce or extinguish the discount and expense on funded debt. (See income account No. 548, "Amortization of discount on funded debt," and balance-sheet account No. 725, "Discount on funded debt.")

* * * * *

GENERAL BALANCE SHEET ACCOUNTS

* * * * *

* * * * *

3. *Discount, expense, and premium on funded debt.*—Ledger accounts shall be provided to cover the discounts, expense, and premiums at the sale or resale of each subclass of funded debt and of receiver's certificates issued for the benefit of or assumed by the company. For explanation of *subclass* see account No. 755, "Funded debt unmatured."

By the term *discount* is meant the excess of the par value of funded debt securities (of whatever kind) issued or assumed, and the accrued interest thereon, over the actual cash value of the consideration received for such securities.

By the term *premium* is meant the excess of the actual cash value of the consideration received for funded debt securities (of whatever kind) issued or assumed over the par value of such securities and the accrued interest thereon.

By the term *expense* is meant all expense in connection with the issue and sale of evidences of debt, such as fees for drafting mortgages and trust deeds; fees and taxes for issuing or recording mortgages and trust deeds; cost of engraving and printing bonds, certificates of indebtedness, and other negotiable paper having a life of more than one year; fees paid trustees provided for in mortgages and trust deeds; fees paid for legal services to trustees relative to mortgage securities; fees and commissions paid underwriters and brokers for marketing such evidences of debt; and other like expense.

The total of the net debit balances remaining in these several accounts should be included in account No. 725, "Discount on

funded debt," and the total of the net credit balances in account No. 772, "Premium on funded debt."

Each fiscal period there shall be charged to income account No. 548, "Amortization of discount on funded debt," a proportion (based upon the ratio of such fiscal period to the remaining life of the respective securities reckoned from the beginning of the period to the date of maturity of the debt to which the charges relate) of each of the debit balances in these accounts, and correspondingly there shall be credited to income account No. 517, "Release of premiums on funded debt," a similar proportion of each of the credit balances in these accounts. Carriers are allowed the option of extinguishing at any time, through charges to Profit and Loss, all or any portion of the debit balances remaining in any of these accounts and of deferring the extinguishment of credit balances until the maturity of the obligations represented.

When any funded debt which has been actually issued to bona fide holders for value is reacquired by the accounting company, that proportion of the balance remaining in the accounts containing discount, expense, and premium on funded debt for the subclass of the security reacquired applicable to the portion reacquired shall be credited or charged thereto, as may be appropriate, and concurrently charged or credited to Profit and Loss. Such proportion shall be based upon the ratio of the par value of the security reacquired to the par value of all the securities of the subclass actually outstanding immediately before such reacquirement.

In case, however, the premium realized or discount suffered at the prior sale of the se-

curities reacquired has been included (in excess of the amount authorized in the text of road and equipment account No. 76, "Interest during construction") in an asset account other than the premiums and discounts account, such asset account shall be concurrently adjusted through Profit and Loss to the extent of such excess of the premium or discount previously included therein with respect to the securities reacquired.

STATEMENTS FROM ACCOUNTING TEXTS

In Arthur Lowes Dickinson's "Accounting Practice and Procedure," the following statements are made (pp. 66, 134):

> Discounts and premiums on bonds are in effect an addition to or deduction from the interest rate paid on the bonds over their life, and as such should strictly be included with interest charges in the net income account by proper instalments each year.
>
> * * * * *
>
> Premium or discount on bonds is a deduction from or addition to the nominal rate of interest which the bond carries; that is to say, there is a rate known as the true or effective rate at which any corporation can place its bonds at par; *if it elects to place them at any other rate the bonds will sell at a premium or discount as the case may be; but the effective rate remains the same and this effective rate is the proper charge to Income account.* Hence the premium or discount should theoretically be spread over the term of the bonds, and the annual instalment thereof credited or charged to Income account each year. (Italics ours.)

Professor Earl A. Saliers, in "Accounts in Theory and Practice," states at pages 171–172:

> *Effective Interest Rate—Bonds Sold at Premium.*—When bonds are sold at a premium the same principles apply as when they are sold at a discount, but the effective rate of interest is less than the nominal rate. Suppose that the issue of bonds had sold at 110 instead of 90. The entry recording the sale follows:

Cash	$11,000	
To Bonds		$10,000
Premium on Bonds		1,000

Full explanation here.

The nominal rate of interest, that is, the rate paid on the par value of the bonds, is 5%. But the actual interest cost per annum is ($500–1/20 of $1,000)÷$11,000, or 4.09% reckoned on $11,000, or $450 per year. This rate of interest considers two factors which the nominal rate, 5%, ignores. The first factor is the $11,000 actually received for the bonds; the second factor is the premium on the bonds, of which 1/20 should be written off each year to reduce the amount of interest charged to Profit and Loss. The entries required are similar to those given above, with such alterations as may be seen by an examination of the following:

Profit and Loss	$37.50	
Premium on Bonds	4.16	
To Interest Accrued		41.66

To charge the Profit and Loss and Premium on Bonds accounts with the month's portion of interest accrued, and to credit the Interest Accrued account with the nominal rate of interest.

If interest is paid semiannually, at the end of each six months' period, Interest Accrued is charged and Cash is credited with $250, as shown above. Any slight discrep-

ancy existing in the Interest Accrued account can be carried to Profit and Loss, as already explained.

Premium or Discount Affects Profit and Loss.—From the foregoing discussion we see that if either a bond premium or a bond discount account is raised on the books when bonds are sold at other than par value, this premium or discount account must be considered as a factor aiding in the determination of the actual interest charge to be made to Profit and Loss. If the bonds sell at a discount, the amount of the discount should be prorated over the time the bonds run, the amount applicable to each period being added to the actual interest paid, i. e., the nominal interest, to determine the amount to be charged to Profit and Loss. If the bonds sell at a premium, the amount of the premiums should be prorated over the life of the bonds, and the amount applicable to each period should be subtracted from the actual interest paid to determine the amount to be charged as interest to Profit and Loss. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1908

CORRECTED COPY pp. 3-7, 5.

SUPREME COURT OF THE UNITED STATES.

No. 349.—October Term, 1931.

Old Colony Railroad Company, Petitioner, *vs.* Commissioner of Internal Revenue. } On Writ of Certiorari to the United States Circuit Court of Appeals for the First Circuit.

[February 15, 1932.]

Mr. Justice Roberts delivered the opinion of the Court.

The Revenue Act of 1921 defines gross income as including gains, profits and income derived by the taxpayer from any source whatever, and provides that in computing net income of a corporation "all interest paid or accrued within the taxable year on its indebtedness" is deductible from such gross income. Treasury regulations promulgated under authority of the statute state that if bonds are issued by a corporation at a premium the net amount of such premium is gain or income which should be amortized over the life of the bonds.[1]

In making return for 1921 the Old Colony Railroad Company deducted from gross income the full amount paid during the year as interest to holders of its bonds. These had been issued at various dates between 1895 and 1904 and the subscribers had taken them at prices in excess of par. The total of the premiums thus paid the company was $199,528.08. At the dates of issuance of the bonds, and until 1914, the company kept its accounts on a cash basis and credited the sums so received in an account designated "Premium on Bonds". In the last named year the Interstate Commerce Commission ordered that they should be amortized over the periods of the respective lives of the bonds. The company complied under protest, extinguished by appropriate entries the ratable proportion of the premiums for the years prior to 1914, and thereafter reported to the Commission as income a yearly ratable proportion of the remainder of the premiums, but entered

[1]Act of November 3, 1921, c. 136, §§ 213, 234; 42 Stat. 227, 237, 254. Treasury Regulations 62, Art. 545.

the same on its books in the profit and loss account (a surplus account) and not as income. The proportion of the premiums attributable to 1921 and reported to the Commission as income for that year was $6,960.64, but the company did not in its tax return include this figure in gross income or deduct it from the amount of interest paid on its bonds.[2] The Commissioner, in his audit of the return, made no adjustment in the item of interest paid, but added the sum of $6,960.64 to the company's gross income for 1921 and found a resulting deficiency in the amount of tax. Upon a petition for redetermination the Board of Tax Appeals held that the Commissioner erred in treating this amount as taxable income of the year in question.[3]

The Commissioner asked reconsideration, asserting that the mere form of the calculation by which he arrived at a redetermination of the tax was immaterial and that the result was correct since the year's proportion of amortization of bond premiums was in reality a deduction from the stipulated interest paid the bondholders. The Board adhered to its ruling.[4] The Circuit Court of Appeals

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[2]By lease dated February 15, 1893, still in force, petitioner leased all its property to The New York, New Haven and Hartford Railroad Company, the lessee agreeing to operate and maintain petitioner's railroad, to assume the payment of the principal of and interest upon its bonded indebtedness and other obligations, and to pay a certain additional sum as rental. Although the bonds in question were issued after the effective date of the lease they were the direct obligation of petitioner and it remained liable for the payment of interest. Petitioner bases certain arguments upon the fact that in the tax year under review it charged itself with bond interest received from the lessee and took credit for the same amount as interest paid to bondholders. These facts are unimportant in the view we take of the case. We shall treat it as if the lease were nonexistent and the bonds had been issued by a company operating its own property.

[3]18 B. T. A. 267. In reaching this conclusion the Board followed its earlier decision in *Old Colony Railroad Company* v. *Commissioner*, 6 B. T. A. 1025, wherein it had held that under similar provisions of the Revenue Act of 1918 and a like treasury regulation the premiums were income in the year in which they were received, thus becoming a part of the company's capital prior to the adoption of the Sixteenth Amendment and not taxable. See *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179; *Lynch* v. *Turrish*, 247 U. S. 221; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Goodrich* v. *Edwards*, 255 U. S. 527. The Board's holding was affirmed in *Commissioner* v. *Old Colony R. R. Co.*, 26 F. (2d) 408.. See also *Chicago, R. I. & P. R. R. Co.* v. *Commissioner*, 47 F. (2d) 990.

[4]18 B. T. A. 267.

adopted the Commissioner's view and reversed the Board.[5] The court distinguished its earlier decision in *Commissioner* v. *Old Colony R. R. Co., supra*, note 3, stating that its attention had not been called to the fact that the profit made in the years prior to 1913 was not being taxed, but was used only to determine the expense of the payment of interest on the bonds for the year 1921. We granted certiorari.

The regulations state that the net amount of premium is gain or income. Necessarily, then, the premium is gain or income of the year in which it is received. The provisions of the Revenue Acts of 1918, 1921, 1924 and 1926 are the same as respects gross income of corporations and deductions therefrom. The regulations under the relevant sections of the acts of 1918, 1924 and 1926 employ substantially the same phraseology as that found in those issued under the 1921 act.[6] The repeated reënactment of a statute without substantial change may amount to an implied legislative approval of a construction placed upon it by executive officers. *National Lead Co.* v. *United States*, 252 U. S. 140; *United States* v. *Farrar*, 281 U. S. 624; *Poe* v. *Seaborn*, 282 U. S. 101, 116.

There is no ambiguity in the language of the regulation, which defines a bond premium as income. As a corollary from this definition it follows that the petitioner received the income represented by the premiums here involved prior to the adoption of the Sixteenth Amendment, for these premiums could not be income for any other year than that in which they were received. That income had become capital prior to the adoption of the Amendment and could not be reached by a subsequent income tax act. This conclusion is not affected by the provision of the regulation which allows the pro-ration or amortization of this item over the life of the bonds, and extends to the taxpayer the privilege of treating the premium as income received in instalments instead of in a lump sum in the year of its receipt.

Nor does the fact that the regulation thus ameliorates the burden of the taxpayer authorize the use of the grant to convert income of years prior to the effective date of the Sixteenth Amendment into income assumed to have been received thereafter. The

[5] 50 F. (2d) 896.

[6] Regulations 45, Art. 544; Regulations 62, Art. 545; Regulations 69, Art. 545; Regulations 74, Art. 68.

amortization requirement may properly be applied to premiums paid subsequent to March 1, 1913, but cannot operate to contradict the definition of a premium as gain or income.

The Government, however, insists that notwithstanding the regulation's designation of a premium paid by the subscriber to corporate bonds as income it is not such to the corporation, but is in the nature of capital loaned which must be returned to the lender during the life of the bonds. Reference is made to the practice of bond buyers in determining the amount they will bid. It is said that a purchaser, in arriving at the price he is willing to pay for a bond, has regard to the current rate of interest for money, and if the bond bears a stipulated rate in excess of the ruling rate he will pay a premium. He does this although he knows that at maturity he can only receive the par of the bond, but considers that he will be repaid the premium by the excess of the agreed rate of interest over the rate he is content to receive. On the other hand, where the stipulated interest is less than the going rate bond buyers will bid less than the par of the bond by such amount as is necessary to redress the difference between the agreed rate of interest and the going rate which the subscriber demands. The conclusion is that the actual return to one who pays a premium is less than the nominal interest carried by the bond, and to one who buys at a discount is greater than such nominal rate. The argument is that although the regulations are inaptly phrased and are susceptible of the construction petitioner places upon them their real intent was to adjust the nominal interest paid on a corporation's indebtedness to the actual amount it is paying for the use of the money represented by the par of the bond,—that is, to what accountants have called the "effective rate" of interest. In this view the Government says that each time the debtor pays an instalment of stipulated interest what it in fact does is to pay interest at a lesser rate on the par of the bond and return a ratable proportion of the premium, which really constitutes a loan by the investor to the debtor. Thus that portion of the instalment paid at each interest date which is a return of the loaned capital represented by the premium must be deducted from the nominal interest in order to arrive at the "effective rate" of interest the debtor is really paying. It is said the regulation is intended to afford a method of adjusting the taxpayer's income in the light

of these facts, and that it is immaterial whether, as provided, the pro rata yearly return of capital loaned in excess of the face of the bond is added to gross income or deducted from interest paid, for in either case the result in dollars will be exactly the same.

Doubtless the premium received by the corporation is acquired capital rather than income. But if this be admitted the concession does not answer the question whether a premium paid prior to 1913 is taxable. Obviously, therefore, it is not enough for the Government's purpose to disregard the regulation which designates this item as income or gain. The Commissioner must and does go farther and contend that the receipt of such a premium reduces the item of interest paid and renders the sum nominated as such in the bond something different from the "interest . . . on its indebtedness" mentioned in § 234 of the Revenue Act of 1921 as a permissible deduction from gross income.

In other words the contention is that by the use of the quoted phrase the statute did not intend to allow the deduction of the amount agreed to be paid, which the contract denominates "interest", but of a different sum to be ascertained by a calculation which will allocate the payment between a partial and ratable return of the premium and "effective" interest on the par of the security.

Is this the reasonable construction of the language of the act,—"all interest . . . on its indebtedness"? The rule which should be applied is established by many decisions. "The legislature must be presumed to use words in their known and ordinary signification". *Levy's Lessee* v. *M'Cartee*, 6 Pet. 102, 110. "The popular or received import of words furnishes the general rule for the interpretation of public laws". *Maillard* v. *Lawrence*, 16 How. 251, 261. And see *United States* v. *Buffalo Gas Co.*, 172 U. S. 339, 341; *United States* v. *First Nat. Bank*, 234 U. S. 245, 258; *Caminetti* v. *United States*, 242 U. S. 470, 485. As was said in *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 370, "'the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow-minded sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover". This rule is applied to taxing acts: *DeGanay* v. *Lederer*, 250 U. S. 376, 381.

Applying the accepted tests to the language of the statute, we are of opinion that the construction contended for by the Commis-

sioner is inadmissible. In common parlance the bonded indebtedness of a corporation imports the total face of its outstanding bonds,—the amount which must be paid at their maturity. The phrase is not generally used to connote par plus an unreturned proportion of premium.

And as respects "interest", the usual import of the term is the amount which one has contracted to pay for the use of borrowed money. He who pays and he who receives payment of the stipulated amount conceives that the whole is interest. In the ordinary affairs of life no one stops for refined analysis of the nature of a premium, or considers that the periodic payment universally called "interest" is in part something wholly distinct—that is, a return of borrowed capital. It has remained for the theory of accounting to point out this refinement. We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountants' phrase "effective rate" of interest and intended that as the measure of the permitted deduction.

In the present case, as with corporate obligations generally, the bond has a par value and each coupon stipulates that on a date therein mentioned the company will pay a named sum as interest on the bond. Until the present contention was put forward no one supposed that the taxpayer was not entitled to deduct the entire amount specified in the coupon and actually paid during the taxable year as interest. The person who receives this sum certainly considers it interest and so, apparently, does the Government, which requires him to return it all as such and does not permit him, if he or his predecessor holder paid more than par for the bond, to treat part of the sum received as a return of capital loaned and the remainder as interest received.

In short, we think that in the common understanding "interest" means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words of the statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and theoretic analysis.

If there were doubt as to the connotation of the term, and another meaning might be adopted, the fact of its use in a tax statute

would incline the scale to the construction most favorable to the taxpayer. *Gould* v. *Gould,* 245 U. S. 151; *United States* v. *Merriam,* 263 U. S. 179; *Bowers* v. *Lighterage Co.,* 273 U. S. 346; *United States* v. *Updike,* 281 U. S. 489; *Burnet* v. *Niagara Falls B. Co.,* 282 U. S. 648.

A further contention is advanced that inasmuch as by the ruling of the Interstate Commerce Commission the company was compelled to designate the annual amount of premium amortization as income, and under protest did so treat it in reporting to the Commission, the ruling of the Commissioner of Internal Revenue is in conformity with the method of bookkeeping adopted by the petitioner and hence is justified by § 212 (b) of the Revenue Act of 1921,[7] which provides that the net income of a corporation shall be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, and by § 213 (a) of the same act, which authorizes the accrual method of reporting income. This position is inconsistent with the other arguments advanced. If the amortized premium is to be deducted from interest paid by the taxpayer it is not income. If it is income, then by hypothesis it is income received prior to the date of the Sixteenth Amendment and not income which accrues to the taxpayer from year to year. Moreover, the rules of accounting enforced upon a carrier by the Interstate Commerce Commission are not binding upon the Commissioner, nor may he resort to the rules of that body, made for other purposes, for the determination of tax liability under the revenue acts. *Kansas City Southern Ry. Co.* v. *Commissioner,* 52 F. (2d) 372; certiorari denied November 30, 1931, No. 495, October Term, 1931. Compare *Chicago, R. I. & P. Ry. Co.* v. *Commissioner,* 13 B. T. A. 988, 1027; *Fall River Electric Light Co.* v. *Commissioner,* 23 B. T. A. 168.

We conclude that the yearly pro rata amortization of bond ~~interest~~ premiums is not income received in the year to which it is applicable; and that so far as the deduction of interest on indebtedness is concerned the fact that a premium was paid does not operate to reduce interest paid on bonded indebtedness within the meaning of the revenue acts.

The judgment is

Reversed.

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[7]Note 1, *supra.*